The Dividend Problem

by Daniel J.H. Greenwood*

Everyone knows that shareholders receive dividends because they are entitled to the residual returns of a public corporation. Everyone is wrong.

Using the familiar economic model of the firm, I show that shareholders have no special claim on corporate economic returns. No one has an entitlement to rents in a capitalist system. Shareholders, the purely fungible providers of a purely fungible commodity and a sunk cost, are particularly unlikely to be able to command a share of economic profits or, indeed, any return at all.

Shareholders do win much of the corporate surplus. But this is not by market right or moral entitlement. Rather, it is the result of a (possibly temporary) ideological victory in a political battle over economic rents. Surprisingly, since corporate law often assumes a conflict between shareholders and top management, shareholder gains flow from the usefulness of the share-centered ideologies in justifying a tremendous shift of corporate wealth from employees to top managers. Burgeoning CEO salaries are part of the same phenomenon as high shareholder returns, not in opposition to it.

Taking the political nature of the corporation seriously will lead to a series of new and important questions. Are current distributions of corporate wealth justifiable, or should corporate governance treat lower-paid employees as citizens instead of subjects? Why should only one side in a political conflict have the vote, and why per dollar instead of per person? Given undemocratic internal corporate politics, are current levels of deference to corporate autonomy justifiable?

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I. Introduction

Everyone knows that shareholders of a public corporation are entitled to its residual returns. Everyone is wrong.

Corporate law scholars sharply disagree over the merits of the nexus of contract theory, which emphasizes a metaphor of the corporation as a largely contractual moment in the market;[1] corporate-finance based views emphasizing that shares and bonds are closely related and often interchangeable;[2] an older fiduciary duty based tradition, which emphasizes the obligations of managers to work for their "principals" the shareholders;[3] and institutionalist views which emphasize information problems and the bureaucratic functioning of the firm.[4] But nearly everyone agrees that the corporation exists to generate wealth for shareholders.[5] Both those who claim that shareholders "own" the

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[1]This view has its locus classicus in Armen A. Alchian and Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777 (1972) (contending that firm is a purely voluntary market phenomenon with no elements of coercion or fiat) and Michael Jensen & William Meckling, *Theory of the Firm: managerial behavior, agency costs and ownership structure*, 3 J. FIN. ECON. 305 (1976) (describing the firm as a nexus of contracts and reduction of agency costs as the central issue). It currently dominates the elite law schools despite criticisms dating back decades. See, e.g.,KRAAKMAN ET AL, THE ANATOMY OF CORPORATE LAW (2004) (proclaiming and exemplifying hegemonic dominance of nexus of contracts theory); William W. Bratton, Jr., *The "Nexus of Contract" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989) (surveying and criticizing the approach) ; Arthur Allen Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451 (1974) (raising basic objections to economic approach).

[2]For introductions to the corporate finance view, see, WILLIAM A. KLEIN & JOHN C. COFFEE, BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES; RICHARD A. BREARLY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE (8th ed.). Corporate finance theory emphasizes that the value of stocks, bonds, and even third-party option contracts that do not involve the corporation at all is dependent on the risk-adjusted present value of future cash flows. Accordingly, it teaches that both managers and investors should view these various securities, with the seemingly different roles they represent in the corporation, are largely interchangeable. Like the nexus of contracts view, corporate finance destabilizes the specially privileged position of shareholders and underpins much of the analysis in this Article.

[3]This tradition usually traces itself back to ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932), although modern uses of the book seem radically different from the authors' understanding, see Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th Century American Legal Thought*, 30 LAW & SOC. INQUIRY 179 (2005). Berle and Means' phrase "the separation of ownership and control" contributed the key idea that shareholders could continue to be "owners" of the corporation even though they lack the control over the asset, rights to make decisions, and ability to appropriate its profits that are the legal and economic characteristics of ownership. Some modern writers in the fiduciary duty tradition, following the Dodds side of the great Berle-Dodds debate emphasize that fiduciary duties may run to more than merely shareholders, see, e.g., LAWRENCE MITCHELL, CORPORATE IRRESPONSIBILITY (2001). But the more common version is symbolized by the famous dictum in Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919), "[a] business corporation is organized and carried on primarily for the profit of the stockholders." See infra, n. .

[4]See, e.g., OLIVER E. WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM (1987) (emphasizing transaction costs); HENRY HANSMANN, OWNERSHIP OF ENTERPRISE (1996) (describing corporations as "shareholders cooperative"); Margaret Blain & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (describing corporate form as solution to worker's coordination problems).

[5]*Dodge*, supra; but see, Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989) ("we reject the argument that the only corporate threat posed by an all-shares, all-cash tender offer is the possibility of inadequate value".) For academic discussion, see, e.g., Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS B. L. J. 87, 87-88 (2005) (summarizing state of the debate); Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (contending that share-centrism has won the debate).

firm and those who, following the nexus of contract theory, say that "ownership" is meaningless in this context,[6] agree that shareholders are entitled to have the firm operated in their interest. Indeed, even when the shareholders are the same people as other firm participants–most corporate shareholders today are institutional investors which often also hold bonds and may also be fiduciaries for current or past employees at the corporation, its suppliers, its customers or its competitors–courts and theorists alike assume that the firm should grant the shareholder role primacy.[7]

Contrary to the conventional wisdom, however, basic economic analysis of the modern public corporation demonstrates that shareholders have no special claim on a corporation's economic returns.[8] Economic profits are rents. No one has an entitlement to economic rents in a capitalist system.[9] Shareholders, the purely fungible providers of a purely fungible commodity, are particularly unlikely to be able to command a share of economic profits. Indeed, since the contribution of shareholders to the firm is a sunk cost, in a competitive market shareholders are unlikely to earn any return at all. Accordingly, market-based analyses of the firm should conclude that shareholder returns result from a market distortion.

Similarly, black-letter legal doctrine makes clear that shareholders have the same legal right to dividends as waiters have to tips: an expectation that is not enforceable in court. Metaphorical claims that shareholders are "owners" suffering from a "separation of ownership and control" or "principals" suffering from "agency costs," or even "trust beneficiaries" conceal but do not overcome the legal reality. Shareholders have political

[6]Alchian & Demsetz, supra n. at fn.14, for example, note that shareholders need not be considered owners but can be thought of as investors like bondholders. More fundamentally, much of modern corporate finance is based on Miller & Modigliani's insight that from the perspective of the firm, equity and debt are largely interchangeable, and the firm's value is largely independent of which it uses to finance itself. Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. OF BUS.411 (1961). If bonds and shares are interchangeable, of course, the "ownership" rights of shareholders must be unimportant. Cf. David Ellerman, *Capital in 'Capitalist' and in Labor-Managed Firms*, SSRN 633722 (2004) (noting that economic understanding of firm as production function does not imply that "capital" owns the firm in the sense of being the residual claimant). Even the standard Brearly & Myers corporate finance textbook, which assumes throughout that managers ought to be maximizing shareholder return, mysteriously states that the firm "should try to minimize the present value of all taxes paid on corporate income ... includ[ing] personal taxes paid by bondholder and shareholders," as if bondholders had precisely the same status as shareholders. BREARLY & MYERS, supra n. at 473. They do not explain why tax avoidance should be a firm goal, why firms should view themselves as aliens exempt from responsibilities incumbent on all citizens, or why shareholder and bondholder taxes are different from personal taxes paid by suppliers, customers, or employees; apparently it is self-evident that the firm should consider as its own concern the personal finances of these financial investors, but not other factors of production..

[7]Perhaps the most dramatic judicial proclamation of shareholder primacy is Revlon v. MacAndrews, 506 A.2d 173 (1986), in which the court enjoined certain defensive measures in a hostile takeover because they favored bondholders over shareholders, without regard to whether bondholders were helped more than shareholders were hurt, even though the facts made clear that the two groups heavily overlapped and without more detailed information on actual holdings it was impossible to tell whether investors would view their bond or share holdings as more important.

[8]See infra, section III.

[9]On the concept of "rents" as used in the public choice and law and economics literature, see, e.g., Mark Kelman, *On Democracy Bashing*, 79 VIRGINIA L. REV. 199, 227 (1988) (describing rent-seeking, when it is worthy of condemnation, and ambiguities in concept).

voting rights in an organization, not the rights of an owner of property, a principal in an agency relationship or a beneficiary of a trust.[10]

The implications are clear: shareholders win some of the corporate surplus not by market right or moral entitlement, but due to a (possibly temporary) ideological victory in a political battle over economic rents. Surprisingly, since conventional wisdom portrays corporate law as a conflict between shareholders and top management, those conflicts are dwarfed by the common interests of the two groups. Shareholder returns are largely the consequence of managers finding the share-centered ideologies useful as an ideological justification for a tremendous shift of corporate wealth from employees to the CEO/shareholder alliance.

Whether the public corporation is viewed as a trust, agency relationship, nexus of contracts, property or person, standard accounts conceal the internal political struggles over corporate surplus and the weakness of shareholder claims to appropriate it. Taking the corporation's political nature seriously, in contrast, leads to a series of new insights and related questions. If the struggle over corporate surplus is a political struggle over economic rents, why should only one side, the shareholders, have the vote? In a democratic society, why should those votes be allocated on a per-dollar basis, instead of a per-person basis? Indeed, to the extent that shareholders are only a role, and market forces make it a limited and narrow role, is it plausible to believe that the stock market is often a reasonable proxy for the public good? Most fundamentally, why should we, the citizens of the United States, allow our major economic actors–which are also among our most important governing institutions–to treat their employees–us–as foreigners and outsiders, denied not only the vote but even a legitimate claim to the surplus they help create?

In the last several decades, virtually all corporate gains from productivity have gone to shareholders and CEOs, while ordinary employee wages have remained flat or declined.[11] This system is obviously not well designed to generate employee loyalty to the firm (or the firm productivity that follows): employees not given a fair share of the wealth they help produce are likely eventually to notice, and employees who view themselves as exploited are unlikely to cooperate fully in their exploitation. Nor is the rapidly growing gap between the elite and the rest of us healthy for republican democracy: if the rich really are different from the rest of us, the common enterprise of nationhood fails. If shareholders have no special claim to corporate rents, then existing corporate governance is not only dysfunctional but simply unfair.

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[10]See infra, section III.A.4.

[11]The problem has been noted by many commentators, both inside the large corporate sector of the economy that is my focus here and more generally. See, e.g., Paul Krugman, *Feeling No Pain*, 3/06/06 NY TIMES, ("Between 1979 and 2003, according to a recent research paper published by the I.R.S., the share of overall income received by the bottom 80 percent of taxpayers fell from 50 percent to barely over 40 percent. The main winners from this upward redistribution of income were a tiny, wealthy elite: more than half the income share lost by the bottom 80 percent was gained by just one-fourth of 1 percent of the population, people with incomes of at least $750,000 in 2003."). For a general discussion of the changes in distribution of wealth and income in the United States over the last two generations, see, EDWARD N. WOLFF, TOP HEAVY: THE INCREASING INEQUALITY OF WEALTH IN AMERICA (1996).

All is not lost, however. If the share-centered corporation is not the inevitable result of ineluctable economic law, we are free to adopt different corporate governance rules giving other participants more power, making firms both more just and more likely to succeed in their basic wealth-creation task.[12] Allocations of surplus have no efficiency implications. Thus, we need not fear a tradeoff between "efficiency" and justice: reforming the internal political processes of our corporations to make them better reflect basic democratic values should not lead to loss of wealth. On the contrary, just as democratic political systems more consistently generate wealth than dictatorial ones, expanding corporate democracy should increase the firm's productivity.

II. The Problem

In the last third of the nineteenth century, American law abandoned its earlier understanding that corporations, endowed with special privileges by act of the legislature, were inherently public in their purposes and quasi-governmental in their operations.[13] In the great divide of liberal political theory between state and citizen, public and private, corporations began to be seen as private, less a part of the state than requiring protection from the it, more like citizens than their governments.[14] Indeed, by 1886, : the Supreme Court found it completely uncontroversial that corporations arebecame entitled to the same protections of the equal protection clause of the Fourteenth Amendment as rights of humans under the due process clause in 1886.[15]

Similarly, corporate purposes were reconceptualized. Corporations were no longer understood as existing to promote important public projects but rather to promote the private interests of their particular participants–even though the largest corporations of the period, the railroads, were engaged in an enterprise of extraordinary public importance, were the beneficiaries of massive land grants and other public subsidies, and were collective enterprises of a scale hitherto unknown to American governments. On

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[12]As an aside, a realistic understanding of the corporate struggle over allocation of surplus suggests that the corporate income tax needs to be rethought. Current tax law presumes that payments to all factors of production other than shares are business expenses reducing profits, while all payments to shareholders are made out of profits. A more realistic system might deny deductibility to any payment to an employee that is more than 5 times the median wage, and grant deductibility for dividends paid to shareholders under some reasonable level. More radically, we might abandon the inherently complex attempt to define "income" for entities and instead shift corporate taxation to a VAT or equivalent.

[13]See, e.g., MORTON J. HORWITZ, TRANSFORMATION OF AMERICAN LAW 1780-1860 111-114 (describing transition from public to private theories of corporation); HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW, 1836-1937 13-14 (1991) (describing transition from mercantilist to classical model of corporation)..

[14]Cf. Gerald Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1059, 1075-76, 1100-02 (1980) (describing differentiation of municipal from business corporations and classification of former as public, latter as private).

[15]Santa Clara v. Southern Pacific RR, 118 U.S. 394 (1886). See, MORTON J. HORWITZ, TRANSFORMATION OF AMERICAN LAW, 1870-1960, ch3: *Santa Clara Revisited* (1992) (describing Santa Clara's prefiguring of later theories of corporate personality). From Earle to Pembina, the Supreme Court consistently upheld differential taxes on corporations: corporation were not citizens. From Algeyer (1897) on, however, business corporations are given essentially the same rights against the government as people, generally without any discussion whatsoever of whether assimilating firms to citizens is appropriate. See HOVENKAMP, supra n. (discussing cases and transition in legal conceptions of corporation person); Daniel J.H. Greenwood, *Essential Speech: Why Corporate Speech Is Not Free*, 83 IOWA L. REV. 995 (1998) (arguing that rights given to corporations often diminish the rights of their participants); Daniel J.H. Greenwood, *First Amendment Imperialism*, 1999 Utah L. Rev. 659 (1999) (discussing expansion of speech rights, asserted by corporations, into doctrinal territory of *Lochner*-like assertion of 'natural' markets).

the new analysis, this private, self-interested, endeavor would be required to serve the public good, if at all, only by means of Adam Smith's invisible hand, not by any conscious public spiritedness or deliberate consideration of the needs of the public.[16] By the turn of the twentieth century, the state generally abandoned the attempt to control corporations through corporate law, instead using external regulatory law, offering them subsidies or otherwise relieving them of the rigors of the market.

In this world of private public corporations aiming for profit, the obvious question arises: which corporate participants will be allowed to benefit from the surplus the firm generates? The most famous answer appears in Dodge v. Ford Motor Co.:

> "a business corporation is organized and carried on primarily for the profit of the shareholders. The powers of the directors are to be employed to that end. The discretion of directors ... does not extend to a change in the end itself."[17]

But *Dodge* is an outlier.[18] Since the first of the recognizably modern general business corporation laws at the turn of the century, the basic rule instead has been that corporations choose their own ends and police them internally with almost no judicial or other state intervention. As the RMBCA states, a corporation may "be formed for any lawful purpose."[19] Moreover, governance of the firm is the virtually exclusive province of the board, with minimal judicial supervision limited by the business judgment rule's presumption that board actions may not be challenged in court.[20] Thus, in contrast to *Dodge's* external command, the usual rule stresses the firm's autonomy. The board of directors of a corporation has extraordinary flexibility in determining how to apply any surplus the firm may earn.

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[16]Adam Smith himself, of course, wrote that corporations would never serve the public good; however, he was working within the older, public, paradigm of corporations. ADAM SMITH, THE WEALTH OF NATIONS 700 (Corporations "very seldom succeed[] without an exclusive privilege; and frequently have not succeeded with one. Without an exclusive privilege they have commonly mismanaged the trade. With an exclusive privilege they have both mismanaged and confined it."). Early 19th century Americans frequently shared this distrust of the large corporation. See, e.g., Hovenkamp, supra n. , at p. 367 (describing Jeffersonian hostility to corporations); JAMES W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION 31-45 (describing suspicions of Gouge (1833) and others regarding corporations, echoing Smith almost verbatim).

[17]Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919) (ordering board of directors to declare a dividend despite their own views and views of majority shareholder). Although *Dodge* is perhaps the most extreme judicial statement of the privatized view of the corporation as existing solely for the benefit of its shareholders, the general attitude was, and remains, common. See also, e.g., ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) 5, 9 (describing the rise of the modern "quasi-public" corporation, but perceiving this as a problem because corporations were no longer subject to "the old assumption that the quest for profits will spur the owner of industrial property to its effective use").

[18]See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VIRGINIA L. REV 247, 301 (1999) (describing *Dodge* as "highly unusual").

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[20]Current Delaware law enshrines the principle of directorial supremacy in Del. Gen. Corp. L. § 141(a)'s proclamation that "[t]he business and affairs of every corporation ... shall be managed by or under the direction of a board of directors." The business judgment rule, best understood as a form of judicial deference analogous to judicial deference to agency and legislative decisions, see Daniel J.H. Greenwood, *Beyond the Counter-Majoritarian Difficulty: Judicial Decision-Making in a Polynomic World*, 53 RUTGERS L. REV. 781 (2001) (discussing judicial deference in these and other contexts), similarly ensures that directors are the primary corporate decision-makers.

A. Economic and Accounting Profit Contrasted

To discuss shareholder returns, it is first necessary to clarify terms. Profit is an ambiguous term. Common accounting understandings confuse two separate issues: whether the firm is earning a return, on the one hand, and which firm participants are receiving the return, on the other.

A successful firm is one which creates a surplus. It *could* sell its product for more than it *must* pay its various inputs. I will refer to this surplus as the "residual" or "economic profit." A firm that is able to produce a product or service which can be sold for more than the market value of the various inputs is a firm that is successfully creating value–what it produces is worth more than what it consumes.[21]

Economic profit, so defined, is quite different from the more familiar accounting or legal profit bookkeeping concepts. Accounting profit is equal to the sum of properly declared dividends plus so-called retained earnings (referring, roughly speaking, to funds the corporation holds but has not allocated to any corporate participant[22]). On the other side of the ledger, all payments made to corporate participants, other than dividends, reduce accounting profit. Thus, any amount the firm pays its employees, any amount the firm does not obtain from its customers, and any amount the firm pays its investors in the form of interest each reduce accounting profits. Dividends, in contrast, are treated as if they were not costs at all.

The accounting view is not a realistic picture of the corporation's economic success from a social perspective. When a firm needs capital to create its product, the price of that capital is a cost just like all other costs. If it earns an accounting profit insufficient to allow it to pay dividends sufficient to attract the capital it needs, it fails just as surely as if it is unable to pay market wages or market price for raw materials. Conversely, if a firm is able to sell its product for more than the costs of its inputs, it is successful, even if it pays out that surplus in some form other than dividends.

Thus, on the economic view, what counts is not the firms' actual payments for inputs but the market cost for those inputs (including the cost of acquiring capital); not the price it actually does receive but the price it could obtain; not what it does with its surplus but the size of the surplus in the first place. Economic profit classifies as a cost normal (market) returns to any input, including capital, regardless of legal label or accounting treatment. Similarly, economic profit classifies as profit any payment to any input in excess of the market price necessary to acquire that input, regardless of accounting treatment. Thus, any part of dividends or interest that is necessary to obtain capital on the market is a cost. Any payment above that necessary cost is part of the

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[21]See infra, fn. .

[22]Retained earnings do not, however, represent a future fund available for payments to shareholders, despite older understandings to that effect. On the one hand, the corporations may easily distribute retained earnings to other corporate constituencies, whether by choice or market pressure, in the form of increased payments to other inputs or decreased prices to customers. On the other hand, dividends may be paid out of other sources, including future period earnings or economic profit, borrowing, or sales of assets. Indeed, retained earnings do not represent a fund at all: they are not, for example, a synonym for cash on hand or liquid investments.

firm's economic profits (which has been distributed to bondholders or shareholders respectively).

In short, economic profit is a theoretical measure of the surplus available to the corporation to be distributed among its various participants, inputs, patrons or customers, while accounting or legal profit is a formal measure of the funds distributed to shareholders in the form of dividends or classified by the firm as retained earnings. The distinction should be familiar. Before check-the-box taxation, it would have been surprising to see a successful closely held corporations report an accounting profit; publicly traded corporations often manipulate accounting conventions to the opposite effect.[23]

In a theoretical fully competitive market, of course, prices are driven down to costs. It follows that, as I have defined it, economic profit is a disequilibrium producer's surplus: an imbalance in the market in which price is (or could be, at the seller's option) higher than cost.[24]

When economic profit exists, typically it will be difficult to calculate, because surpluses exist only when markets are less than perfectly competitive, and if a market is imperfect, the market price of inputs and product may be imprecise as well.[25] Nonetheless, the concept is essential. Economic profit is the pie that is available for distribution, the fund which can be struggled over, regardless of where it ends up.

B. Who Owns the Economic Profit?

It is fundamental to the very notion of corporate existence that any economic profit or surplus belongs in the first instance to the corporation itself and not to any of its various participants.[26] Accordingly, it is the corporation's board or its delegates,

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[23]See supra n. (on retained earnings).

[24]See e.g, Kamin v. American Express, 383 N.Y.S.2d 807 (N.Y. Sup. 1976) (upholding accounting treatment that management believed would improve stock market perceptions of profit despite consequence of higher income tax obligation). Since the development of the LLC and "check the box" pass through taxation, closely-held firms generally can elect not to pay entity-level tax without manipulating accounting profit labels. However, manipulating labels remains important for other reasons. Leveraged buyouts, for example, which pay out surplus in the form of interest, were highly useful in convincing employees to accept a smaller share of corporate surplus: Employees who might have protested had the company insisted it needed employee give-backs in order to increase its profits were willing to pitch in to stave off bankruptcy, even when the cash flows were identical transfers of a slice of the corporate pie from employees to capital. Similarly, CEOs of publicly traded companies discovered that stock option grants allowed them to transfer corporate surplus to themselves with minimum publicity and, until recent reforms, no impact on reported profits.

[25]In competitive markets, each input will be priced at (or marginally above) its value in its next most profitable use, and the product should be priced at (or marginally below) the cost of production of the next lowest cost producer. At that level, the firm will have as large a supply of inputs and be able to sell as much of its product as it wishes. A firm earning an economic profit is one that can pay those prices and sell at that price and have something left over: it is more efficient than its competitors. As other firms learn, they should compete away that advantage. However, in less competitive markets firms may be able to earn economic rents – i.e., sell their product for more than economic costs – for extended periods of time. This Article is concerned with the distribution of those rents or surplus. In a fully competitive market at equilibrium, there are no surpluses; if any factor of production (including capital) succeeds in demanding more than competitors pay, the firm will be driven out of business.

[26]Del. Gen. Corp. L. § 122 (granting corporation, inter alia, powers of permanent succession, ownership, contracting, etc.). Individual shareholders have no right to dissolve a corporation or otherwise force the corporation to distribute any of its assets to the shareholder. See, e.g., Del. Gen. Corp. L. § 275 (dissolution of corporation is by resolution of the board followed by vote of shareholders). In contrast, in a partnership, any partner has the right at any time to demand his or her

operating as the decision-makers for the institution itself, who decide what to do with this economic surplus and how to classify it for legal purposes.[27]

Rather than declare a dividend, the board and executives[28] may decide to reinvest economic profits–that is, to increase the firm's contractual obligations, thereby distributing the former period's profit to the next period's corporate contractual participants. They may pay it to employees in the form of higher salaries or increased managerial benefits. They may distribute it to creditors by paying debt before it is legally due or in the form of interest on new debt. They may distribute it to customers by reducing sales prices or to suppliers by increasing purchase prices. They may decide to simply retain it in the corporate bank account or other financial investments. Or they may decide to distribute it to shareholders, by means of a dividend, dissolution of the firm or a stock buyback.

If the board chooses to retain the economic surplus in the corporation's name beyond the end of an accounting period, or distributes it to shareholders, the economic surplus will become profit in the accounting and legal sense. But nothing forces a board to do that: if it prefers not to have accounting profit, it can simply increase its contractual obligations during the period in which the surplus is earned.[29] In this case, no profit will ever appear on the corporation's books. Instead prices will be lower or input costs will be higher than they need to be.[30]

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pro rata share of the partnership assets (including, of course, any surplus from prior periods). See, e.g., U.P.A. § 31 (granting every partner the right to dissolve the partnership even in contravention of partnership agreement); U.P.A. § 38 (granting every partner on dissolution rights to pro rata share of partnership assets, except that wrongfully dissolving partners are not entitled to share in value of good-will).

[27]Del Gen. Corp. Law § 141 (business and affairs of every corporation managed by or under direction of its board), §170 (board may declare and pay dividends, subject to certain restrictions); RMBCA § 8.01 (all corporate powers shall be exercised by or under the authority of its board); § 6.40 (board may authorize distributions to the shareholders, subject to certain restrictions).

[28]Hereafter, I will generally refer just to the board–with the understanding that in practice most relevant decisions will be made in the first instance by executives and many may never even be submitted to the board for ratification. For current purposes, the specific allocation of power between board and executives seems unimportant.

[29]Precisely the same problem arises in the corporate income tax context. The income tax is levied on profit, defined as revenues less expenses allowable as deductions. Corporations, therefore, may be tempted to reduce their taxable profits (and therefore taxes) by creating expenses beyond those required by the market. See, e.g., IRC § 162 (allowing corporate deduction for "reasonable" executive compensation, even when the executive is also a (or the sole) shareholder). In contrast, payments to a partner of a partnership are ordinarily classified as profit, even if the partner contributed time to the partnership. See U.P.A. § 18.

[30]The standard corporate finance text, BREARLY & MYERS, supra n. (4th ed. at 324), formerly asserted that "retained earnings are additional capital invested by shareholders, and represent, in effect, a compulsory issue of shares." Obviously this is not true in any literal sense; shareholders have not contributed anything at all and no shares have been issued. Instead, B&M explain, "a firm which retains $1million could have paid the cash out as dividends and then sold new common shares to raise the same amount of additional capital." Indeed, as Brearly & Myers appear to be aware, id. 8th ed. at p 417, generally corporate law would permit a corporation to borrows $1million and immediately pay it out to shareholders; thus their logic suggests that most borrowing should be viewed as a "additional capital invested by shareholders" and the failure to distribute it as "a compulsory issue of shares." In Brearly & Myers's world, the shareholders magically create all value in the firm regardless of the contributions of others. What they fail to consider is that the firm could also have paid out its retained earnings or any other available cash as salary (or bonuses to suppliers, or discounts to customers, or made any other legal use of it) and then borrowed or sold shares to raise the same amount of capital. So we could just as well say that retained earnings were contributed by employees and represent a compulsory reduction of salary. This shareholder claim to corporate funds is no more than Sophistic spin.

Legal restrictions on this board discretion are few. Shareholders have a legal right to the surplus only after the board of directors declares a dividend.[31] The duty of care requires the board to take whatever action it takes after due consideration.[32] The duty of loyalty prevents the board from giving away corporate assets without receiving an appropriate quid pro quo.[33]

Even where the duty of care or loyalty might seem to restrict board discretion, however, the business judgment rule severely limits judicial review of board decisions. In effect, courts police only insider deals, in which a dominant shareholder or other insider receives corporate assets on terms not available to others.[34] Even then, courts mainly look for secret deals, routinely declining to second-guess the decisions of informed independent directors.[35] Thus, no American court has yet set any limit to the amount a public corporation's fully informed board may publicly pay its CEO, even in the absence of any evidence that the board had any basis to think the CEO's services could not have been obtained for less.[36] So long as the board does not appear to be unduly influenced by the CEO, modern courts do not intervene even if the firm appears to be giving the bulk of its economic profits to the CEO, just as courts during the unionized age did not intervene when companies appeared to be being managed primarily in the interests of unionized employees and middle-level managers, or when companies have taken their product or even a particular way of doing business as their primary goal.[37]

[31]Id.; cf. RMBCA §6.40(f) (declared dividends treated as an unsecured debt to the shareholders at parity with other unsecured debt).
[32]Smith v. Van Gorkum, 488 A. 2d 858 (Del. 1985); RMBCA §8.30 (setting out duty of directors to act in good faith and in a manner the director reasonably believes to be in the best interest of the corporation).
[33]Cinerama v. Technicolor, 663 A.2d 1156 (Del 1995) (setting out procedural test for determining possible breaches of duty of loyalty); re Wheelabrator, 663 A.2d 1194 (Del Ch 1995) (similar); RMBCA §8.31 (a) (2) (iii) (lifting director's protection against suit for breach of duty on, inter alia, showing of lack of objectivity due to interest); § 8.60 (setting out requirements for actions challenging director's conflicting interest transactions).
[34]Joy v. North, 692 F.2d 880 (2d Cir. 1982) (defending business judgment rule on ground that judicial abstention promotes risk taking by managers).
[35]See, e.g., KRAAKMAN, ANATOMY,supra n. at p. 115 (describing the largely procedural approach of fiduciary duty law). Even the leading case finding liability follows this procedural approach, never suggesting a limit on the right of a fully informed board to operate the corporation in the interests of any party it chooses. Smith v. Van Gorkum, 488 A. 2d 858 (Del. 1985) (finding uninformed board liable). The RMBCA permits a conflicting interest transaction to stand if it is either approved by a majority of informed, unconflicted directors or shareholders or it is entirely fair to the corporation. RMBCA § 8.61-8.62).
[36]Brehm v. Eisner, 746 A2d 244 (Del. 2000) at n. 56 and p 263 (noting that there is a point at which executive compensation becomes actionable waste, but according "great deference" to board judgment because the "size and structure of executive compensation are inherently matters of judgment"); In re Walt Disney Co. Derivative Litigation, 2005 WL 2056651(Del. Ch. 2005)(similar).
[37]Corporations have been managed with different primary goals in different periods. See, e.g., BERLE & MEANS, supra n. at 67 (discussing instances in which corporations were managed on behalf of the "control" rather than passive shareholders); JOHN K. GALBRAITH, THE NEW INDUSTRIAL STATE (contending that major corporations were, at that time, managed on behalf of employees, growth and stability, with little concern for consumers or shareholders). Courts have also declined to intervene when managers have described their goals as furthering the interests of the product or even particular ways of doing business, rather than any human party. See, e.g., Paramount Communications v. Time Inc., 571 A.2d 1140 (Del. 1989) (directors stated that they sought to run corporation in order best to protect "Time Culture"); Cheff v. Mathes, 199 A.2d 548 (1964) (court appears to approve company's dedication to a particular sales method).

In short, the board has legal discretion to treat the economic profits–the residual–in virtually any way it pleases. Within the broad limits of the business judgment rule, the board *may* do almost anything with the residual.

C. Who Should Get the Residual?

Nonetheless, commentators and courts routinely ask what the board *should* do with the corporation's profits. And the answer has seemed obvious to many: profits are rightfully for the shareholders.[38]

But economic profits are rents, and as a general rule, no one has a moral entitlement to rents. When cooperation creates a surplus in a market economy, normally we assume that the parties are free to bargain to any division of it. If shareholders can win some, all power to them. But if they cannot, they have nothing to complain about. As we shall see, however, it is virtually inconceivable that shareholders would be able to win a share of the rents in a competitive market. Shareholder returns, therefore, must be the result of a non-competitive process that can not be legitimated by market claims.

D. Shareholders as insurers or residual risk bearers

[38]Even Lynn Stout, who has questioned most aspects of the shareholder primacy model in the course of de-essentializing the fictional shareholder, continues to assume that ultimately the goal of the corporation is to make money for shareholders. See, e.g., Lynn Stout, Bad and Not-So-Bad Arguments For Shareholder Primacy, 75 S. CALIF. L. REV. 1189 (2002). For a recent survey of the remarkable consensus in favor of the shareholder-centric model of the corporation, see Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 39-41 (2004).

Modern theories of corporate finance describe shareholders as the residual risk bearers of a corporation, assuming the first risk of loss in return for a suitable payment for insurance services.[39] In other words, shareholders are paid to diversify away some of the risk of business failure or success that would be difficult for other, less diversified, corporate participants to bear.[40] On its face, the explanation is insufficient. In no other context do insurers claim a right to have the insured act solely in the insurers' behalf, let alone to have the entire surplus generated by the insured enterprise turned over to the insurer. However, on closer examination, the problems are more fundamental.

One could easily imagine a contract along these lines, in which prospective investors offered funds to the firm in return for a share of future profits, if any, or losses, if not. On average, if investors and firms are able to properly assess the odds of business success, investors would be paid the cost of the funds they provide, but variance from that average might be high.

This deal might be attractive to both sides. Shareholders can diversify more easily than most other participants in the corporation; employees, in particular, are likely to be deeply invested in firm specific assets (seniority, firm-specific skills and knowledge, and so on) and therefore poor risk bearers. Accordingly, investors that can diversify easily could usefully and cheaply provide insurance against business failure. This imaginary insurance contract is the foundation of most corporate finance models of the corporation and is often thought to describe the workings of the stock market. The problem is that it does not reflect the actual rights of shares in a public corporation.

First, the basic claim that shareholders are the primary risk-bearers of the firm fails the giggle test. Every reader of the business pages knows that firms are far less likely to cut dividends in order to increase wages and employment than the other way around; employees, not shareholders, are the first to bear the burdens of the inevitable challenges a dynamic capitalist economy presents to existing institutions. If shareholders are meant to be smoothing the business cycle for other corporate participants, they have not been doing their job.

Second, shareholders do not in fact enter into such a contract (or any contract at all). The share relationship is fundamentally non-contractual–it is, instead, political in nature. Most fundamentally, share rights do not come from any agreement. Shareholders typically purchase their shares on the secondary market and therefore are not in privity with their fellow shareholders, the firm or any other firm participants.[41] Moreover, once

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[39]In contrast, Alchian & Demsetz argue that the residual is the proper reward for team monitoring services. Supra n. at 782 (giving the residual to the monitor solves the problem of "who monitors the monitor"). Alchian & Demsetz resolve the obvious problem that public shareholders are in no position to monitor team production in the firm by invoking the market for corporate control. Id at 788-9. As described infra, section III.C, that market no longer seems powerful enough to impose shareholder will on corporate managers, even if shareholders had the necessary knowledge and incentives, id. at 788 (describing shareholders as free riding shirkers).

[40]See, e.g., Jensen & Meckling (1984).

[41]The fact that shareholders typically are not in privity with the corporation is a principal reason why state law insider trading doctrine, which proceeded on a somewhat contractual view of fraud, failed to police much. Modern federal insider trading doctrine is based not in contract but fiduciary relationship. *Compare* Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933) (stating that directors are held to high standard of fiduciary obligation with respect to transactions in the company's

they have entered into relationship with the firm, their rights can be changed without their consent: even when the shares (as a group) have rights to veto board decisions, the shares always decide by dollar-weighted majority vote.[42] Majority rule is characteristically political and decidedly contrary to the contractual norm of individual consent.[43] Indeed, even were the shareholder relationship fairly described as contractual, the contract has no content–as discussed above, shares have no legally enforceable contract rights to "future profits."

Finally, the imaginary contract wouldn't work, which is probably why it doesn't exist. In order for investors to contract to receive disequilibrium profits, they would have to be able to specify a method for determining them that a court could enforce. Mere accounting conventions would be inadequate, for the reasons discussed above: accounting conventions accept the classification of payments to factors of production managers give, and cannot, for example, distinguish between market price and above- or below-market price, or between market salaries and above- or below-market salaries, and so on.

Economic (as opposed to accounting) profit is no more useful. Any court that attempted to determine whether corporate expenditures were or were not required by the market would descend into a morass of unknowables. Even distinctions that should be possible in principle will be virtually impossible to make in fact. What trial evidence, for example, would be required to prove that a manager paid a given price in order to obtain the profit maximizing level of quality, rather than too high a price or too low a quality?

The risks of indeterminate litigation would persuade any competent manager to find some other source of investment capital, while investors would flee "opportunities" governed by a contract that surely would prevent managers from exercising the judgment they are paid to have. Indeed, the only way for managers to conclusively demonstrate that they paid and received no more than market value would be to run the firm by auction. But a constant auction is a market, not a firm at all.

Thus, even were courts able to insist on profit maximization, the very demand would be self-defeating. Managers constrained to pay no more than market price and

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stock, but holding that they were entitled to purchase plaintiff's stock without disclosing insider knowledge, in part because they purchased stock on an anonymous exchange), *with* US v. O'Hagen, 521 U.S. 642 (1997) (setting out modern insider trading doctrine under Exchange Act §§ 10 (b) and 14(e), pursuant to which trading on material, non-public information in violation of a fiduciary duty or when the information was misappropriated is prohibited without regard to privity or ordinary fraud rules).

[42]In contrast, partnership law is closer to contract and agency law in its understandings. Thus, the UPA creates a default rule that any change to the partnership agreement, including admission of new members, be made by unanimous consent. 18(g) (admission of new members be by unanimous agreement); 18(h) (acts in contravention of agreements between partners are rightful only with unanimous consent). Moreover, the UPA follows the usual contract rule that personal service contracts may not be enforced by injunction and the agency rule that agency may be ended at any time by either party, by providing that each partner has an inalienable right to dissolve the partnership even in violation of the partnership agreement. See supra, n. and accompanying text. Corporate law has no equivalents.

[43]Horowitz points out that the majority rule principle is found in the American cases as early as 1809, and views it as a holdover from the eighteenth century view that the core of the corporate form is the municipal corporation. See, I MORTON HOROWITZ, THE TRANSFORMATION OF AMERICAN LAW 111, n. 7. The political origins of the business corporation influence other aspect of contemporary law as well, cf., Daniel J.H. Greenwood, *The Semi-Sovereign Corporation* (draft available at http://www.law.utah.edu/greenwood).

always to charge the maximum the market can bear would be unable to plan for the future or second-guess the market. Instead of the firm being a refuge from the market, a small haven for centralized planning and predictability, it would simply reflect momentary market fluctuations. But such a firm would have no comparative advantage over the spot markets to which it would be a slave, and would therefore fail.[44]

Even if shareholders were insurers, and even if the "insurance contract" could be made enforceable, it is hard to understand how they could bargain to win the entire economic surplus of the firm (or, indeed, any of it), as the imaginary contract contends they have. Insurers are no different from other factors of production–they should be paid their marginal cost, no more. Even as insurers, the marginal cost of publicly traded equity is zero; even its average cost should be no more than the risk-adjusted cost of money and should be independent of absolute amount of the corporation's excess returns even if it varied with them.

Shareholders are not entitled to profits by law. They are not entitled to them by economic right. Are they entitled to them at all?

III. The Market Model: The Dividend Mystery

In this part, I explore the difficulties of understanding shareholder claims to the residual within economic understandings of the firm. I have attempted to keep the economic model mainstream, because I believe the problem of the equity claim on the firm is fundamental–it exists independently of the details of the competing economic models.[45]

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[44]See generally, Coase, supra n. .

[45]Modern economically oriented models of the corporation come in a wide variety of forms. Classic models took the firm as a "black box," treating it as if it were a single producer without investigating its internal dynamics. Coase argued that this obfuscated the issue of why firms exist in the first place, which he contended could only be due to an efficiency advantage resulting from eliminating the market's pricing mechanism internally. Firms, thus, should exist where the market generates poor results and administration ("fiat" in his terms) can generate better ones. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (1937) reprinted in R.H. COASE, THE FIRM, THE MARKET AND THE LAW (1988) 33-57, and in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT (edited by Oliver E. Williamson, Sidney G. Winter) (1991).

Theorists have since developed Coase's insight in several different directions. Institutional economics focuses on the internal dynamics of the firm. Williamson's transaction cost economics focuses particularly on the micro-economics of contract failure that might lead to firms, while Hansmann has used a similar approach to explore corporate governance and, importantly for this Article's analysis, distribution of ownership rights in the firm. More recently, Blair & Stout have emphasized the role of the corporation as a "mediating hierarchy" in resolving such problems of team production and Stout has begun to consider the implications of abandoning the fiction that shareholders have a single and uniform interest. Blair & Stout, supra n. ; Stout forthcoming. See also, Daniel J.H. Greenwood, *Fictional Shareholders: 'For Whom is the Corporation Managed,' Revisited*, 69 S. CALIF. L. REV. 1021 (1996). Others, such as Alchian & Demsetz, supra n. , and Jensen & Meckling, supra n. , and their followers, have gone in the opposite direction, treating the firm itself as no more than a moment in the market, a nexus of contracts understandable without any need to refer to the institution itself; this approach was early-on critiqued for its mystification by Arthur Leff and Bill Bratton, and more widely followed, reaching its quintessence in books by Roberta Romano and Easterbrook & Fischel. Recent market-based theories have sought to apply the insights of sophisticated behavioral finance theorists such as Andrei Shleifer to model the behavior of shareholders, thought of primarily as participants in a finance market rather than "owners" of a company. Communitarians including Larry Mitchell have emphasized the importance of trust and its social bases, often assumed and therefore neglected in older economic models. Mark Roe has usefully emphasized that efficiency considerations always exist within a particular political framework, so that market evolution may lead to different results in different contexts.

In standard nexus of contract and most other economically oriented models, shareholders are viewed as a factor of production like all other factors of production in the firm.[46] Firms need capital (among other things) in order to produce their product, and they purchase or rent that capital in the capital markets.[47] Roughly speaking, they purchase capital by selling stock; they rent it by issuing debt.

Treating the stockholders as factors of production who have sold capital to the firm has the heuristic advantage of emphasizing that from the firm's perspective, the capital market is a market like all others, in which an array of commodities is for sale or rent at a variety of market-determined prices. Here, as in any competitive commodity market, a purchaser (i.e., the firm) has no reason to pay anything more than the competitive price, and that should equal its marginal cost of production. Thus, we can state the puzzle:

Shareholders are perfectly fungible providers of the most perfectly fungible of commodities (cash and some risk bearing services), in our most competitive of markets. A priori, then, one would expect that they would receive no more than the market price for their product, which should equal its marginal cost of production.

If so, it is surprising to find that shareholders expect to share in any excess returns the firm may obtain. Rather, one would expect that any disequilibrium or monopoly firm profits would be retained by the firm itself or go to a firm participant with disequilibrium or monopoly power. Public shareholders–because they are fully fungible providers of a fully fungible commodity is a highly competitive market–are the *least* likely firm participants to have that kind of power.

Bond holders and bank lenders are in fact paid precisely in this manner: they receive a fee that is closely related to the general cost of producing money (i.e., general interest rates), adjusted to reflect the expected risk of the particular firm. They do not expect to participate in extraordinary firm earnings, except perhaps to the extent that such earnings reduce risk for which the creditors have already been compensated.

But equity is harder to understand. First, some background.

A. Full competitive equilibrium

Under standard economic models, a firm selling a commodity product in a fully competitive equilibrium market must sell its product at a price equal to the marginal cost of production of the lowest-cost firm. If it sets its price any higher, customers will purchase from a competitor and it will fail. This is normally expressed in standard black box models by stating that a firm in fully competitive markets earns no economic profit.

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[46]HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996) 12-16 (treating firm as a capital cooperative). The current article may be seen as a claim that the market problems identified by Williamson and Hansmann as reasons for the firm structure we see–principally, lock-in, asymmetric information and marginal/average cost difference problems–have *not*, in fact, been solved by the existing legal structures.

[47]See, e.g., BREARLY & MYERS, supra n. at 445 (describing the full interchangeability of debt and equity financing under Miller and Modigliani's proposition 1 and partial interchangeability under competing theories).

At equilibrium there are no internal distribution issues within the firm. Each factor of production must be paid no more than its lowest cost on the market, or the firm will have higher costs of production than its competitors and will be unable to compete. If any factor of production were to successfully demand more than its replacement cost, it would, parasite-like, kill its host.

Capital is no different than labor or raw materials in this model. It must be paid the lowest possible amount necessary to generate the minimum possible capital to run the company–that is, its cost of production in a competitive market. If it is paid more than that, the firm's costs will be higher than its competitors and it will be unable to price its product competitively, leading to failure.

Actually, the prognosis for shareholders is even worse. In competitive markets, prices normally adjust to marginal cost. Equity capital usually will be a sunk cost with a marginal cost of zero.[48] Shareholders, then, should expect no return at all at competitive equilibrium. Consider the following.

B. The sunk costs problem generally

It is a commonplace of economic theory that when marginal costs are lower than average costs with respect to real factors of production, prices will reflect only the marginal costs.[49] When this occurs, the firm will be operating at a long-term loss, and the result should be market failure. Either the product will not be produced, a monopoly will avoid market pricing, or allocation by market prices will be replaced by a non-market process such as administrative allocation inside a firm.[50] This is said to be the problem that drove the American railroads out of business (and continues to be a regular problem in high fixed cost businesses such as telecoms and airlines). It once motivated J. P. Morgan's attempts to end "ruinous competition" by consolidation. Later, it underpinned New Deal "natural monopoly" theories. And Coase famously contended that avoiding it is the major reason firms exist.[51]

1. Market pricing at marginal, not average, cost

To see the problem, imagine a simplified firm using capital, labor and raw material inputs to produce widgets. Assume that a single employee operating a single widget making machine can produce 100 widgets from 1 unit of proto-widget raw material. The cost of producing 100 widgets, then, consists of variable costs of 1 unit of proto-widget and 1 day of labor, plus the fixed costs associated with the machine (roughly, the cost of the machine divided by the number of widgets it can be expected to make over its useful life).

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[48]See, e.g., OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM, 33, 53, 263 (1985) (emphasizing the importance of relative asset specificity in creating contracting problems and possible institutional resolutions).

[49] See, e.g., Ronald Coase, *The Marginal Cost Controversy*, 13 ECONOMICA 169 (New Series, 1946).

[50]Coase, supra n. .

[51]See, e.g., JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA (describing history of corporation); – (describing J.P. Morgan); Coase, supra n. (criticizing New Deal understandings of monopoly).

Ex ante, of course, no one would invest in the machines unless they expected to be able to charge a price for widgets sufficiently above the variable costs to cover the costs of the machine (and some extra for the effort). Thus, internal accounting methods will always include a cost for the machine itself, typically in the form of amortization of fixed costs, and firms normally will calculate their per-widget costs on an average basis.

But ex post, after the machines are in place, the calculation changes. If the firm has a machine sitting idle, the cost of producing an extra batch of widgets is determined only by the variable costs. The machine adds nothing to the firm's cost of producing these 100 widgets nor does leaving it idle save anything. In other words, the marginal cost of producing an additional 100 widgets is simply 1 unit of proto-widget and 1 day of labor. A firm faced with the choice of leaving the factory idle or dropping prices to increase demand will find that it will make more money (or lose less) if it drops prices to just above marginal (variable) cost and keeps producing. Moreover, by staying in operation, it preserves employee networks and loyalty and keeps the equipment from rusting away from neglect. Closing down, like death, often results in quick deterioration.

But if one firm drops its prices to just above its marginal costs, in a competitive market all firms will be forced to match. With prices at marginal cost, producing firms will not be charging customers for the cost of the (old) machines and (anticipating similar problems in the next period) will not invest in new ones.

2. General solutions

Often we solve this problem by tax-financed subsidies (as in agriculture, highways and single family mortgages), legally imposed monopoly rights or similar barriers to entry (as in drugs, software and other industries dependent on the legal monopolies of patent or copyright, most utilities and many hospitals) or state-administered price fixing (trucking, agriculture, many forms of insurance, etc).

Absent governmental intervention, market failure can take several forms. One possibility is that the various firms will drive each other out of business or that entrepreneurs, foreseeing the problem ex ante, will never invest in the first place. The product simply will not be produced, despite technical feasibility, willing buyers and potentially willing sellers. The best example of this in the United States may be passenger rail service.

Alternatively, the market may solve the sunk cost problem by eliminating competition through monopoly or at least partially price-fixed oligopoly. This was J.P. Morgan's solution to "ruinous competition": to reorganize industries into a limited number of players which could then raise prices sufficiently to cover fixed costs (and then some). In other industries, monopolistic pricing power may stem from cascades, such as the one that allows Microsoft to price Windows well above its marginal cost (which is roughly zero).[52] Many industries with significant sunk costs settle into oligopoly–the common

[52]A cascade occurs when consumers derive value from using the same product as others independent of the merits of the underlying choice. It matters far more, for example, that we choose the *same* side of the road on which to drive, use the instant message service, type on the same keyboard, and share a common computer operating system than that we make the *right* choice. Brian Arthur, *Positive Feedbacks in the Economy*, SCI. AMER. (Feb 1990). Indeed, even where there is no

phenomenon of two or three major producers seen in areas dominated by the old trusts (breakfast cereals, sugar, steel, oil), services (banking, Bar reviews) or new commodities (computer hardware and software, electronics) helps to avoid fully competitive pricing that would be below average cost.

However, monopoly profits attract competitors, so if costs of entry are relatively low or price fixing agreements are difficult to enforce, new entrants (or old competitors tempted to cheat in order to increase volume) will constantly threaten comfortably high pricing. The result may be an industry without an equilibrium, gyrating madly between excess monopoly profits and competitive bankruptcy as firms enter and depart, with prices rarely matching either marginal or average costs. Think of our semi-deregulated airlines, California's electric markets, or farmers selling commodity agricultural produce before the New Deal price support system.

Finally, some industries may be able to reorganize to eliminate the sunk cost problem by eliminating sunk costs. The more an industry uses flexible, readily re-allocable physical capital, the less it needs to worry about the difference between marginal and average costs. Companies using generic machine tools controlled by ordinary computers do not face the same issues as old-fashioned rust-belt dedicated factories.

Similarly, even where the equipment itself remains highly specific, competitive industries may develop around it. Doctors, for example, avoid the sunk cost problem because their expensive non-redeployable equipment is owned by hospitals (which, in turn, often have local monopolies) and parts of their enterprise such as billing and payroll with high technological economies of scale are outsourced. Lawyers need not form monopolistic firms because much of the physical capital they need is either socialized (courts) or oligopolistic (Westlaw and Lexis).[53]

C. Financial capital as a sunk cost

The fixed capital problem is generally discussed in terms of real assets–widget machines, airplanes, railroad tracks, CT-scanners, law libraries, fiber optics lines or electric plants. But it applies to purely financial assets as well.

Corporations often hold financial assets in the corporate name. Since securities are easily redeployed, rational managers should price them at their opportunity cost (i.e., the most profitable available alternative use), which is therefore their effective marginal cost.

But the equity contributed by stockholders to a public firm generally is a sunk cost. Stockholders have no legally enforceable right to a dividend. Thus, there is no legal cost to using funds shareholders contributed to the firm in the past. Conversely, there is no opportunity cost: the corporation cannot profit from not using past public offering

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obvious advantage to standardization, it still often remains more important to go to the same movies, listen to the same music, wear the same clothes or join the right club as our peers than it is to find the best of those products. [Hansmann on coops/clubs] When a cascade occurs, the producer of the favored product may be able to charge monopoly prices despite the existence of competitors. Even if the competing product has similar technical specifications, with the customer base it cannot provide true substitutability.

[53] HANSMANN, supra n. , at p. .

proceeds either. Thus, unless stockholders have some extra-legal, non-market ability to demand payment, the firm's marginal cost of continuing to use the assets stockholders have invested is nil.

If the marginal cost of this asset is zero, however, it should command no return in a competitive market. Any firm that increases its prices to create a fund from which to pay shareholders would have to charge more than its marginal cost and therefore, in a competitive market, more than its competitors. That would put it out of business.

Accordingly, no part of a corporation's earnings in a competitive market at equilibrium is attributable to shareholders' contribution. On the contrary, all positive earnings must be attributed to different inputs that do have positive marginal costs. At competitive equilibrium the corporation will not only fail to earn economic profits (by definition), it will fail to earn legal profits representing a normal return to equity capital.

Since the claim is so counter-intuitive–after all, shareholders do pay good money in the expectation of future returns–let us take the argument more slowly.

1. Shareholders have no legal/contractual right to distributions

First, shareholders have no legally enforceable right to a dividend or other distribution from the firm. As a matter of formal law, this is clear.

Shareholders have no right to any interim payments for the continued use of their capital and firms have no legal obligation ever to declare a dividend or any other distribution even if there is a surplus available to do so. The decision to declare a dividend rests in the exclusive discretion of the board.[54]

Perhaps even more fundamentally, shareholders have no contractual right to their money back. Quite unlike standard partnership law, which provides that each partner has the unalienable right to withdraw his capital at any time,[55] corporate law gives shareholders no opportunity to regain their capital without the firm's consent. To be sure, shareholders generally have the right to sell their shares to someone else, but this transaction does not withdraw funds from the firm.[56] The corporation continues to hold the capital paid by the initial stock purchaser regardless of what happens in the secondary market.[57] The only way shareholders will get a return of the capital they have contributed to the firm is for the firm to decide–by vote of its board of directors, usually followed by a vote of the shares–to repurchase its shares or declare a liquidating dividend.[58] This is a political, not contractual, right.

[54]See, e.g., Del. G. Corp. L. § § 141 (a) (determining that business and affairs of every corporation shall be managed by or under the direction of the board of directors); 170 (a) (granting directors sole power to declare dividends).

[55]See, e.g., UPA § 31 (permitting any individual partner to dissolve partnership at any time, in accordance with or in breach of the partnership agreement); § 38 (granting each partner at any time the right to either a winding up and distribution of the surplus or to payment of the "value of his interest in the partnership").

[56]See, e.g., RMBCA 6.27 (authorizing corporation to impose restrictions on transferability of shares (the assumed default rule)).

[57]The U.S. Supreme Court's suggestion in *Bellotti v. National City Bank* that a shareholder unhappy with managerial actions (in that case, political contributions) can withdraw at any time thus is based on a misunderstanding of corporate law.

[58]See, e.g., Del. G. Corp. L. § 160 (authorizing corporation to purchase and redeem its own stock); 170 (allowing board to declare dividend); 224 (allowing board to reduce capital); RMBCA § 12.02 (requiring board resolution followed by shareholder vote for certain dispositions of substantial assets); 14.02 (providing that dissolution requires board resolution

In early corporate law, it seems to have been assumed that firms would be created for a specific project (such as a particular trading voyage) and last for a limited period after which they would wind up, distributing the original contributions and any accumulated profits (or losses) to the shareholders.[59] Dividends were thought of as interim payments against this final settling up.

In sharp contrast, modern corporate law assumes the firm will last indefinitely and does not provide for winding up after a particular project or a given amount of time.[60] If a firm declares a dividend or similar distribution, or decides to wind up, the shareholders generally have a right to a pro-rata share of the dividend or the residual on winding up after other claimants are paid.[61] But this right exists only after the firm's board–not the shareholders–has declared the dividend or decided to wind up. There is no equivalent to the right of individual partners to cause dissolution. Indeed, shareholders lack even a collective right to dissolve or to order the board to do so.[62]

Moreover, distributions to shareholders are always subject to the prior claims of parties with contractual claims on the corporation.[63] But contracts do not just appear as an act of God. The board has exclusive authority to cause the corporation to enter into contracts or to authorize its agents, the employees, to do so. That means that not only can the board refuse to declare dividends from legal profits, it may even decide that the firm

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followed by shareholder vote). The fact that shareholders have no claim on funds that remain inside the firm underlies the standard corporate finance theorem that the value of public shares is no more than the present value of the expected future dividends. See, e.g., BREARLY & MYERS, supra n. at 64.

[59]The expectation prior to the mid-19th century was that business firms (generally not incorporated) would exist only for a short period to complete a specified task, such as a single shipping trip. After each trip, the firm would be wound up and the profits distributed to investor/owners even if the expectation was that the same investor/owners would participate in the next ship. Even firms without obvious end-points were normally organized with limited life spans: recall, for example, the Jacksonian controversy over the rechartering of the Second Bank of the United States. See, e.g., Hurst, supra n. at 25 (stating that most early charters set "sharp limits on corporate life"). Similarly, until near the end of the nineteenth century, business corporations were ordinarily restricted to a single, narrowly defined purpose. E.g., Hurst at 44. Partnership law retains this presumption in its provisions for dissolution of the partnership and requirement of unanimous consent for any fundamental change in the business. See, e.g., UPA §§ 18 (h) (requiring unanimous consent for changes to partnership agreement); 18 (g) (requiring unanimous consent of existing partners for any person to become a partner); 31 (permitting any partner to dissolve partnership at any time, in accordance with or in breach of the partnership agreement); 38 (granting each partner at any time the right to either a winding up and distribution of the surplus or to payment of the "value of his interest in the partnership").

[60]Modern corporate law allows corporations to be organized for any or every lawful purpose and to change purpose without shareholder consent, see, e.g., Del. G. Corp. L. § 102 (3) (voiding prior doctrine regarding limited purposes of corporations), permits a corporation to exist indefinitely, see, e.g., Del. G. Corp. L. § 122 (1) (providing for perpetual succession), and places power of dissolution in the corporation itself. See, e.g., Del. G. Corp. L. §122 (7) (granting corporation power to wind itself up).

[61]See, e.g., Del. G. Corp. L. § 151 (providing that classes of stock shall have the rights, preferences, etc., specified in the Articles or applicable board resolution).

[62]See, e.g., McQuade v. Stoneham, 263 N.Y. 323 (1936) (declaring void contract that attempted to bar directors from exercising their business judgment); Grimes v. Donald, 1995 WL 54441, mem op at 7 (Del. Ch. 1995), aff'd., 673 A.2d 1207 (Del. 1996) (prohibiting board from entering into arrangements that would substantially restrict board's ability to manage the corporation); Abercrombie v. Davies, 123 A.2d 893 (Del. Ch. 1956) (similar); Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch.1998) (upholding pleading that "dead hand" poison pill is invalid because, unlike pill upheld in *Unocal*, it would "interfere with the board's power to protect fully the corporation's (and its shareholders') interests").

[63]See, e.g., Del. G. Corp. L. §170 (limiting corporation's ability to declare dividends in order to protect contracting parties).

will never have unencumbered funds from which shareholder distributions could legally be made.[64]

In short, as far as the text of modern business corporation laws is concerned, a corporation could exist indefinitely without ever making any payment at all with respect to its shares. Of course, that a firm is *permitted* to fail to declare a dividend does not mean that it *will* do so. To reach that conclusion requires one more step.

2. In competitive markets, corporations cannot charge for their use of shareholder funds

From the corporation's perspective, if shareholders have no right to withdraw their capital and no right to demand payment for its continued use, the corporation has no variable costs associated with continuing to use the capital provided by shareholders. Once a firm has sold shares to the public, the funds paid for the shares belong to the firm and it can use them freely with no further payment. In other words, the marginal cost of continuing to use assets contributed by shareholders is zero.[65] In competitive product markets, as discussed above, price tends to drop to marginal cost.

Since dividends are not a legal cost, they will not be treated as an economic cost. Rather, as far at the firm is concerned, they are simply a gift, voluntary transfers made out of profits, not costs incurred to earn profits. The market will prevent firms from paying them as effectively as it would prevent making any other charitable gift or paying any legally externalizable cost out of firm funds. Firms that increase prices to fund voluntary payments for shareholders will be outcompeted by firms that do not

Thus, in a competitive market equilibrium, publicly traded firms with capital contributed by shareholders should run economic losses (because economic profits treat normal returns to capital as a corporate expense necessary to produce the product, and they will have no returns to equity capital). Similarly, absent manipulation, they will have no accounting or legal profits. Use of shareholder capital has no marginal cost, and competitive markets will drive prices down to marginal cost.

Were shareholders unexpectedly able to demand payment of a dividend, in a competitive market the net result would only be to drive the firm out of business. By hypothesis, there is no surplus from which to pay the dividend. In order to pay one, then, the firm must either offer below-market wages to some other input or charge above-market price for its product. Neither behavior is sustainable. In a competitive market a firm that paid dividends would be a high cost producer and would fail.

[64]See, e.g., Del. G. Corp. L. § § 141 (a) (determining that business and affairs of every corporation shall be managed by or under the direction of the board of directors); 170 (dividends may be declared only out of surplus or net profits).

[65]Hansmann's description of the business corporation as a capital cooperative is, therefore, incomplete with respect to public corporations. In Hansmann's model, a business corporation would "pay member a fixed interest rate on their loans, set low enough so that there is a reasonable likelihood that the firm will have net earnings after paying this interest and all other expenses. The firm's net earnings are then distributed pro rata among its member according to the dividends they have lent, with the distribution taking place currently as dividends, or upon liquidation." Hansmann, supra n. at 14. In the public corporation as we know it, shareholders do not have a right to demand either dividend or liquidation. Thus, they are not "owners" or "members" in Hansmann's sense unless they have market or political, rather than legal or contractual, power to enforce the hypothetical deal that Hansmann postulates.

D. The unsustainable public equity market

If this were a correct description of the actual workings of our markets, stable and competitive capital markets would be unusual and difficult to maintain. Ex post, firms would find themselves unable to charge customers for the use of shareholder capital unless they can escape competitive product pricing. Ex ante, in competitive product markets, shareholders should expect to earn no return. Prospective shareholders should foresee this problem and refuse to invest unless they expect monopoly pricing.[66]

The net result should be a failure of the public equity capital market. Investors should be willing to lend to public companies, since bondholders and other lenders are entitled to a legally enforceable rate of return. But knowing that equity, having no legal entitlement to a payment, will not receive any return in competitive product markets, they should simply decline to provide equity capital.

Even in less competitive product markets, shareholders should expect no return. Firms at competitive disequilibrium may generate economic surplus. In the long run, standard economic theory predicts that competition will force its distribution to consumers in the form of lower prices. In shorter terms, firms may be able to retain some of the surplus. But nothing in the competitive account suggests that firms will give the surplus (or even normal returns) to shareholders. Rationally maximizing firms will not give free gifts when free riding is an option.

IV. No Exit: Fiduciary Duty Law's Failure

Shareholders do not have right to sue for dividends or return of their capital, but they have equitable rights–the right to sue for breach of fiduciary duty–which might appear sufficient to make companies treat them *as if* they had a right to ongoing payments.

A. Fiduciary duty: the interests of the corporation

Some cases–notably *Dodge*[67] and *Revlon*[68]–purport to find an enforceable right to returns on shares in the general fiduciary duty of care, which requires managers to manage the firm in the interests of the corporation.[69]

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[66]Alternatively, if investors are assumed to be rational, the existence of a public market for a company's stock should be prima facie evidence that it has monopoly pricing power. This, of course, is not the current state of anti-trust law.

[67]See supra n. .

[68]See supra n. (holding that once directors decide that the sale of the company is inevitable, their sole duty is to maximize the price to be received by shares, disregarding other corporate participants even in the factual situation presented, where many shareholders were likely to have interests in corporation in other roles). Later cases have made crystal clear that absent a decision to sell the company, the board has no duty to maximize returns to shares in any identifiable time frame. See, e.g., *Time*, supra n. . Corporate finance theory suggests that time frame is irrelevant for shareholders (since share prices should reflect the present risk and time discounted value of all future returns). However, from an enforcement perspective, returns that may come at any time at all are the same as returns that may never come. Thus, directors have no enforceable duty to maximize share returns at all. See infra TAN (Red Queen).

[69]For the fiduciary duties of directors, see, e.g., RMBCA § 8.30(a) ("Each member of the board of directors... shall act ... in a manner the director reasonably believes to be in the interests of the corporation"). In Delaware, these duties are separated into the duty of loyalty, namely the director's obligation to act "in the good faith belief that her actions are in the corporation's best interest," Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch.2003), see also, In re Walt Disney Co., 2004 WL 2050138 (Del.Ch. 2004) (holding that the "duty of loyalty ... imposes an affirmative obligation to protect and advance the interests of the corporation and mandates that a director absolutely refrain from any conduct that would harm the corporation), and the duty of care, namely the requirement that "in making business decisions, directors must consider all

On its face, a duty to manage the firm in the corporation's best interests doesn't seem to offer much support for the shareholder position. Standard doctrinal formulations either don't mention shareholders as all–as in the RMBCA formula, also widely used in the Delaware cases, which refers to the "interests of the corporation"[70]–or they mention them in a context that makes clear that shareholder interests and firm interests are different and potentially in opposition–as in the alternative Delaware "interests of the corporation and its shareholders" formula.[71]

Shareholder distributions facially fail these tests, if taken seriously. As we've seen, dividends are a gratuitous expression of appreciation for past services already rendered–that is, a gift. In the absence of a quid pro quo, gifts to shareholders are no more in the corporation's interests than any other form of charity.

At most, perhaps dividends can be understood as some sort of vague good will advertising meant to entice future purchasers of future equity issues by creating a reputation for generosity.[72] Rational potential shareholders, however, would not be susceptible to this reputational gambit due to a final period problem. Successful companies rarely need or want to issue additional equity to the public markets. That is, as soon as the company is capable of generosity to its shareholders, it loses the incentive to be so. Accordingly, rational shareholders would assume that companies will no longer care about future shareholders (and therefore no longer pay dividends to current ones) as soon as they are successful. But if current dividends will not deceive rational shareholders into believing that the firm will provide future dividends after it no longer needs shareholders, then even the current dividends do not serve the corporation's interests, and rational, self-interested corporations should decline to issue any dividends at all. If shareholders are factors of production in a more or less normal arms length relationship with the corporation, as the nexus of contracts theory suggests, a duty to act in the "interests of the corporation" makes gratuitously transferring corporate funds to them more, not less, problematic.

The only way to generate a duty to distribute corporate returns to shareholders from the directors' duty to act in the best interests of the corporation is to conflate shareholders and corporation. Were it the case that the corporation has no interests other than the shareholders' interests or that the corporation has no existence separate from the shareholders, then the corporation would "be" its shareholders. This would suggest that giving corporate money to shareholders would be at least not in contravention of the

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material information reasonably available," Brehm v. Eisner, 746 A.2d 244, 259, 264 (Del. 2000) (also noting that Delaware duty of care is purely procedural). See also Del. Gen. Corp. L. § 145 (permitting indemnification of directors and others who act in "good faith and in a manner the person reasonably believed to be in or not opposed to the interests of the corporation").

[70]See prior fn.

[71]See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del.1993) ("directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders.")

[72]Compare, A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145 (1960) (upholding charity contributions, inter alia, as a sort of advertising).

corporation's interests, since it is only moving money from one pocket to another of the same person.

The fact that courts often use the "corporation and its shareholders" formula as interchangeable with the "best interests of the corporation" formula offers some support for the notion that shareholder and corporate interests are the same.[73] Unfortunately, viewing the corporation as the same as its shareholders makes a mess of the law.

Separate existence is the fundamental point of incorporating. The key characteristics of the corporation–legal personality, permanent existence, limited liability, entity-level taxation and centralized management–all flow from its separateness. The corporate veil separating shareholders from corporation means that neither is responsible for the debts of the other, neither is the agent of the other, neither can contract for the other. It prevents individual shareholders from holding up the firm by threatening to withdraw capital at inopportune times or to veto new business opportunities.[74] It is necessary to convert real, complicated, human shareholders into fictional investors, thus allowing business managers to focus on a few simple goals instead of all the problems of collective existence.[75] In short, the rule that a corporation is not its shareholders is what makes a corporation a firm instead of an evanescent moment in the market on the one hand or a full self-governing political community on the other.

Viewing the corporation as the same as its shareholders also contradicts our leading theories of the firm. Nexus of contract theories tend to disparage the view of lawyers and sociologists that the corporation has an independent existence, instead reducing it metaphorically to a mere fictional point in a web of contracts. However, making the corporation disappear does not make it into its shareholders. Like the corporate finance approach from which it descends, nexus of contracts theories assume that shareholders are simply a factor of production like all others. Debt and equity are largely interchangeable, not fundamentally different claims. But that means equity has have no more claim to the firm surplus than anyone else. No one has a pre-legal right to economic rents.

The duty of care and duty of loyalty are duties to the corporation, not to its shareholders. If fiduciary duties to the corporation require paying dividends, it will be to the same extent that they require paying wages or fuel bills–firms must pay their factors of production their market value in order to attract and retain them. But the surplus created by the corporation belongs to the corporation. Giving away corporate assets obviously is not in the interest of the corporation in any normal sense; it is hard to see how it could be mandated by such duties. In fact, if there were anyone with standing to bring the lawsuit, the easier claim would be the opposite one–that paying dividends is waste, defined in

[73]See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del.1993), where the court uses the "corporation and its shareholders" formula to gloss a quotation that uses the "best interests of the corporation" formula without any suggestion that the two phrases might have different meanings.

[74]Lynn Stout has recently reemphasized the importance of potential conflicts of interest among shareholders.

[75]See, *Fictional Shareholders*, supra n. .

Delaware as "an exchange that is so one-sided that no business person of ordinary sound judgment could conclude that the corporation has received adequate consideration."[76]

B. The autonomous corporation: the business judgment rule

Moreover, even if the law could be read to include a fiduciary duty to run the corporation on behalf of its shareholders, it is hard to see how a court could force a board to create shareholder returns without itself taking over the business.[77] For a firm to survive it must create new contractual obligations, and each new obligation means less left over for the shareholders. There is no mechanical or objective answer to the question of which cash flows are surplus and which are costs of the next period.

Perhaps as a result, substantive fiduciary duty doctrine is of no use at all in solving the sunk cost of equity problem. Not only do courts decline to force boards to *maximize* share returns, as a rule they don't attempt to require boards to provide shareholders with *any* returns whatsoever (at least outside of the narrow "*Revlon* Mode" that begins when the board determines to sell the company).

Moreover, even were fiduciary duty doctrine substantively helpful in avoiding the equity sunk cost trap, it would be procedurally inadequate. Courts, especially since the *Carolene Products* Footnote 4, have largely defined their competence in procedural terms.[78] Corporate law is no exception. The business judgment rule reflects the judicial view that the primary fora for addressing controversies regarding corporate management are the boardroom, the managerial hierarchy and the stock markets and that courts should generally respect the outcome of struggles among those power structures just as they defer to the decisions of the political branches of government.[79] The business judgment rule, then, is best understood as a rule of institutional competence, analogous to agency deference rules in public law.

Modern corporate law provides that a corporation is managed by its board of directors.[80] In order to prevent shareholders from shifting the locus of decision-making to courts, courts must defer to board decisions.[81] The business judgment rule restates this fundamental principle of corporate politics: So long as the board has exercised its business

[76] In Re Disney, slip op. at 111 (2005), quoting Brehm v. Eisner, 746 A.2d at 263.

[77] See, e.g., Joy v. North, 692 F.2d 880 (2d Cir. 1982) (defending business judgment rule on ground that "after-the-fact litigation is a most imperfect device to evaluate corporate business decisions").

[78] United States v. Carolene Products Co., 304 U.S. 144 (1938), fn 4 (affirming New Deal rejection of substantive due process and leaving most constitutional issues to the electoral process and legislative-executive branches, but providing for more significant judicial review where issues of the integrity of those process are raised).

[79] See, e.g., Aronson v. Lewis,473 A.2d 805 (Del.1984) ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a)"); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del.1993) ("The [business judgment] rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation.").

[80] Aronson v. Lewis, 473 A.2d 805 (Del.1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.").

[81] See, e.g., Joy v. North, supra n. .

judgment in good faith, acting in the manner it determines to be in the best interests of the corporation, courts will not intervene on behalf of shareholders.[82]

In effect, the business judgment rule assures that courts normally will not review breach of duty claims. As a result, boards and managers are free to favor non-shareholder constituencies (other than, perhaps, directors themselves) in distributing any surplus that does exist.[83]

1. The business judgment rule's division of labor

Corporate decision-making structure, as created by state corporate law in combination with the Federal regulatory scheme and ordinary practice, reflects a generally sensible division of labor between managers, shareholders, directors and courts. Managers are experts in running companies. Under ordinary principles of agency law, they act for the company in all routine matters, make its decisions in the first instance, and so on. Shareholders, particularly the institutional shareholders that dominate our public stock markets, are specialists in pricing, buying and selling shares. The law ordinarily grants them full autonomy in deciding whether to hold, buy or sell individual shares.

The board of directors formally serves as the principal of the corporation, making decisions where the firm itself, rather than its agents or constituents, must act directly. However, directors are part-timers with only a limited ability to participate meaningfully in corporate governance. In practice, their main responsibility is hiring and firing top management. They also have a key role when managerial and shareholder competencies conflict or overlap, specifically when either managers or shareholders wish to sell the company or engage in certain related radical transformations, such as merger, sale of all assets, dissolution or reincorporation. Since the judicial approval of the poison pill and its statutory equivalents, the combined state/federal regime has provided that virtually all such transactions require the directors' approval, usually followed (except in the case of a tender offer) by ratification by a majority of the shares.

Courts and the law generally allow each of the experts near complete autonomy in their respective areas of expertise, restricting their interference to claims of procedure and overreaching rather than substantive error.[84] As a result, the main policing of

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[82]See, e.g., Gagliardi v. TriFoods Intern., 683 A2d 1049, 1052-3 & n.4 (Del. Ch. 1996) (stating that "to allege that a corporation has suffered a loss as a result of a lawful transaction, within the corporation's powers, authorized by a corporate fiduciary acting in a good faith pursuit of corporate purposes, does not state a claim for relief against that fiduciary no matter how foolish the investment may appear in retrospect .... [The business judgment rule] in effect provides that where a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty.").

[83]See, e.g., Brehm v. Eisner, 746 A.2d 244, 259, 264 (Del. 2000) (noting that "directors' business 'decisions will not be disturbed if they can be attributed to any rational business purpose").

[84]See, e.g., In re Caremark, 698 A.2d 959, 967 (Del.Ch.1996) (emphasizing that business judgment rule protects directors "so long as the court determines that the *process* employed was *either* rational or employed in a good faith effort to advance corporate interests" and that "compliance with a director's duty of care can never appropriately be judicially determined by reference to the *content* of the board decision that leads to a corporate loss" (emph. added).) Although Aronson v. Lewis states that the business judgment rule is a seemingly substantive standard of "gross negligence," even that case both justifies and tests this rule by procedural considerations. Absent the autonomy considerations discussed in the text, exempting directors from the ordinary negligence rules that apply to all other decision-makers would raise serious problems of equal protection: in republics, unlike aristocracies, great responsibility does not automatically produce great privilege.

managers and shareholders is by the peer review mechanisms of market pricing, bureaucratic promotion, and directorial supervision rather than by courts. Shareholders hold or don't, and managers manage, with little judicial supervision.

2. Judicial deference: Time, rational basis inquiry and the BJR

Procedural deference means that shareholders cannot look to courts to create a right to corporate surplus which they are unable to appropriate without judicial intervention. To see the degree of the Delaware courts' deference to managerial and board decisions, consider the centrally important decision in *Time,*[85] in which the issue was the relative authority of board and shareholders in connection with decisions regarding the sale or merger of the company.

Time upheld a decision of Time's board to restructure a planned merger in order to eliminate a shareholder vote and preclude an alternative transaction that, by all indications, would have been vastly more attractive to shareholders. From the perspective of a theoretical undiversified Time shareholder with no other interests or values at stake, the decision is almost incomprehensible. The sums offered by Time's suitor Paramount were so large that the money managers overwhelmingly viewed them as greater than any reasonable estimate of returns to holding Time stock. Were the goal of the court to protect undiversified shareholders, this would be almost a paradigmatic case for restricting managerial overreaching and allowing shareholders to follow the norms of the market–to sell for an unexpectedly and perhaps unreasonably high price.[86]

Instead, the Delaware courts chose to reaffirm the central principle of directorial supremacy. Directors are primarily responsible for setting the corporate agenda and that, as Delaware has repeatedly pointed out, includes setting the time frame in which the corporation will meet its goals. But *Time* stands for a stronger position than mere judicial reluctance to attempt to parse the difference between long and short term. Under Delaware law, the directors control more than merely the timing and means the corporation will use to achieve its ends. They set the corporate ends themselves.

Time defended its decision to eliminate a planned shareholder vote on the ground that it sought to preserve "Time Culture," an ill-defined concept that seemed to center around "the separation of church and state," as Time referred to its policy of separating

[85]Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989) .

[86]In this instance, the stock market's prospective assessment seems to have been on the mark. Time's subsequent history of spectacular executive compensation and the spectacularly unsuccessful merger with AOL are hardly unimpeachable advertisements for the inevitable triumph of managerial capitalism.

However, the interests of stock investors as a whole may well be better met if merger decisions are made by both corporate managers and financial specialists. This may not be immediately obvious. After all, in any particular cash-out merger, shareholders are exiting and thus unconcerned with the successor institution's success. Moreover, narrowly profit-maximizing shareholders would be perfectly happy to sell out to an irrational buyer (for example, one overpaying due to winner's curse) or a rent-seeking buyer (for example, one intent on creating private value by monopoly power) knowing that the buyer will destroy the firm or create social costs in excess of private benefits, even if other firm participants would disagree. However, most shares are held by diversified portfolios, and portfolios have interests that extend beyond the particular stock being sold. In particular, the price of future mergers will reflect participants' estimates of the likelihood of post-merger success. Those estimates, in turn, are likely to be affected by past history. Thus, portfolio managers are confronted with a free rider type problem in any given merger: pressing too hard for maximum exploitation in particular instances is likely to destroy the long-run game.

editorial from advertising staff. Time made no claim that "Time Culture" was necessary or even helpful to maximizing shareholder returns. Indeed, although the court reports the company's paeans to the contribution of "Time Culture" to a superior quality product, it does not purport to determine whether that claim was plausible – it makes no judgment on the quality of Time, People or Sports Illustrated, let alone on the links between "separation of church and state" and the ultimate product.

Nor did Time claim that it was committed to "Time Culture" in all circumstances. "Time Culture" was not written into the corporation's by-laws, let alone its articles of incorporation, and the firm offered no assurances that it would continue to be the policy of the successor corporation. But preservation of Time Culture was the current board's stated policy and the Delaware courts accepted both the goal and Time's understanding of how best to pursue it as within the discretion of the Time board of directors. The board is entitled to determine the corporation's interests, not only the means to reach them.

Thus, business judgment review looks much like "rational basis" equal protection review. Post-*Lochner*, courts largely accepted that legal reasoning can help determine the relationship between a given end and the means to reach it, and can even help clarify the conflicts between differing moral and political principles. But in the end, not legal logic but democratic politics of persuasion must set our ultimate goals and resolve the inevitable conflicts among the infinite aspirations of finite people. In the basic *Carolene Products* Footnote 4 allocation of authority between courts and legislature, the courts conceded that the goals and interests of society are for the legislature to determine; courts recognized that their legitimate role is in determining procedures and mediating disputes within given moral/legal frameworks, not in imposing controversial economic or political theories on the body politic.

Similarly, in corporate law courts largely permit boards to determine, within extremely broad boundaries, what the corporate interests are. Just as the Constitution does not enact the Social Statics of Mr. Herbert Spencer, so too the Delaware Corporations Code does not enact the narrow profit maximization of Mr. Milton Friedman or the short-term shareholder orientation of Mr. Alfred Dunlap. Corporate law, like constitutional law, simply is not rich enough to provide a ready-made legal answer to the issue of how or why to run a corporation.

But if the board can determine what its ends are, virtually any decision it takes will be defensible. Just as classical rational basis review nearly always discovered some legitimate legislative purpose to which even the oddest legislative act could be rationally related, so too business judgment review will nearly always discover that board actions rationally promote some permissible end.

3. The poverty of wealth maximization: multiple ends under the BJR

It may not be obvious that the business judgment rule is this broad. Occasional courts have suggested that corporate boards have only one legitimate goal, to maximize profit for the benefit of shareholders.[87] Given the extreme language of *Dodge* and *Revlon*, litigators and their director clients typically see discretion as the better part of valor and claim that favoring non-shareholder corporate constituencies is in the long term interests of shareholders. However, this seems at best a polite evasion. No one takes it very seriously. Directors explain that they are acting in the long term interest of shareholders even in circumstances where it seems deeply implausible.[88] Courts reciprocate. So long as the favored constituency is not the decision-makers themselves, courts rarely require any evidence that this claim is correct, suggesting that they are not very interested in whether boards in fact view share value as the sole legitimate goal of the corporation.[89]

Willingness to allow boards to choose goals other than shareholder value maximization is also the only rational explanation of the "just say no" cases. In *Unitrin*,[90] for example, the Delaware Supreme Court upheld a board's defensive tactics against an offer that was highly attractive to shareholders on the purported ground that they had to be protected from substantive coercion. But there was no coercion. The facts offer no suggestion why the shareholders were incapable of deciding for themselves between the offer and management's assurances that future profits would justify a higher price still. That decision is, after all, precisely the kind of calculation shareholders are in the business of making. If shareholders cannot be trusted to make that calculation, it is hard to see why they should be trusted at all.[91]

In short, either the Delaware court was radically foolish, or it was somewhat disingenuous. Permission is granted to "protect" shareholders but in fact the permission is broader: to define when and whether shareholders will determine the overall goal of the firm. The easiest way to understand *Unitrin* is simply that the board, not outsiders, decides when or whether shareholder return will be the primary or sole goal of the firm. As we have seen, even when boards have dared to admit explicitly they are not acting in

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[87] In addition to *Dodge* and *Revlon*, see, e.g., State ex rel. Pillsbury v. Honeywell, Inc., 291 Minn. 322 (1971) (barring shareholder from exercising legal right on ground that he was not acting within shareholder role to further proper corporate goal).

[88] See, e.g., Kamin v. American Express, 383 N.Y.S.2d 807 (N.Y. Sup. 1976) (upholding, as in interests of shareholders, directors' intentional decision to pay unnecessary taxes in order to make true financial condition of company less apparent to shareholders); A. P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J. 1953) (upholding charitable contribution on implausible ground that it is really self-interested).

[89] See, e.g., Blair & Stout, supra n. ; or the Vice-Chancellor's complaints in Chesapeake Corp. v. Shore, 771 A.2d 293 (2000) text at fn 65-72 (attempting to make sense of *Unitrin*'s holding that directors may protect shareholders from an offer to sell the company for a high price).

[90] Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995).

[91] Here is how Vice-Chancellor Strine, struggling to understand the decision within a shareholder centered paradigm, describes it: "On the other, the same electorate must be protected from substantive coercion because it (the target board thinks) is unable to digest management's position on the long-term value of the company, compare that position to the view advocated by the tender offeror, and make an intelligent (if not risk-free) judgment about whether to support the election of a board that will permit them to sell their shares of stock." Chesapeake Corp. v. Shore, 771 A.2d 293 (2000) text at fn 72. The Vice-Chancellor's attempt to take seriously the notion that shareholders may only be "protected" leads him to conclude that the Supreme Court's jurisprudence is nearly incoherent. As he quite correctly points out, if the problem is lack of information, the solution should be more information, not allowing the board to preclude shareholder decision-making. Id, Text at fn 78.

shareholder interests, as in *Time*, the Delaware courts have not seen that as a problem.[92] The court must defer to the board's determination that a threat exists as well as its response, and a threat may be to the corporation's goals, not merely to shareholder returns.[93]

C. The Red Queen's jam: the impossibility of timing

Fiduciary duty's inability to guarantee shareholders a return is not an artifact of particular holdings or doctrinal language that could be changed by rejecting *Time,* building up *Dodge* and *Revlon*, eliminating the seeming disingenuousness of courts that pay lip service to a goal of shareholder centeredness but do not demand evidence of it, or reverting to a *Lochner*esque confidence in the power of legal categories to govern complex societies. Even were the courts determined to create an enforceable fiduciary duty to operate corporations only in shareholder interests, they would fail. The problem is fundamental.

Modern finance theory teaches that the price of a share of stock should be equal to the market's estimate of the current risk-adjusted time-discounted value of all future returns to that share (i.e., future dividends plus the final period payment).[94] Because the stock price capitalizes all predicted gains–short and long term–into the share price, individual investors can invest without regard to their own idiosyncratic time preferences. Should the company generate cash later than they need it, they can sell shares, thereby realizing the current discounted value of the future cash. Conversely, should the company generate cash at a time when the investor does not need it, the investor can simply reinvest. Accordingly, in a moderately efficient capital market, stock market investors should be entirely indifferent between long and short term profits, since each will be impounded in the current price of the shares. Courts seeking to require corporate managers to operate the company in the interests of shareholders rationally should respond by focusing entirely on rate of profit, not its timing.

Indeed, were courts to attempt to require firms to profit maximize in some particular time frame, they would destroy one of the key advantages of the business corporation. In modern business corporations, shareholders do not have a right to their capital back at a specified time or on demand. Thus, equity serves as permanent

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[92]*Time,* supra n. . Mark Roe's summary of the law is thus incomplete. Roe states, correctly, that under the business judgment rule, courts police self-dealing by directors and managers, but not incompetence or mismanagement. ROE, POLITICAL DETERMINANTS. But he fails to note that courts do not even view intentional failure to act in shareholder interests as mismanagement. In the absence of self-dealing, US law-in-the-courts delegates to the board decisions of balancing shareholder interests against other firm values nearly as much as in more openly balancing regimes such as the Netherlands. KRAAKMAN, ANATOMY, supra n. . Despite its absence from the law in the books, the shareholder-centered norm is key to understanding corporate law as it stands today. See, e.g., *Fictional Shareholders*, supra n. ; Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, 2004 COLUM. BUS. L. REV. 773. Its power, however, stems from capital market pressures and non-legal norms, such as the metaphoric rhetoric of "ownership," "agency," or "shareholder democracy," rather than the shareholders-uber-alles mandates of *Revlon* and *Dodge*.

[93]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); see also, *Unitrin*, 651 A.2d at 1388-89.

[94]See, e.g., BREARLY & MYERS, supra n. at 64, KLEIN & COFFEE, supra n. .

financing for the firm, independent of market fluctuations. This predictability is key to long term planning and illiquid investments that would otherwise be impractical.[95]

Economic projects do not come in neatly packaged units with fixed end points and many are illiquid for long periods of their expected life. Often, a project could be destroyed if investors were permitted to withdraw mid-stream: a half-built factory, a drug in development or a computer program that doesn't yet work may have little value to outsiders suffering from information asymmetries. Similarly, the secondary market for used factors of production is often imperfect. If buyers have difficulty telling whether a machine or building has been well maintained, they should not be willing to pay full value for it. If the company is required to pay off an individual investor at a time when it is illiquid, it may be forced to raise additional money on unfavorable terms, sell off assets at fire-sale prices, or compromise with the departing investor.

Ex poste, premature winding up can be value-destroying for the remaining investors. Ex ante, foreseeing such problems, investors may be unwilling to invest in an enterprise the success of which is dependent on other investors choosing not to withdraw. Thus, individual investor rights to withdraw, either at will (as in a partnership) or at fixed times (as in many investment pools) can preclude illiquid investing. But illiquid investing–disequilibrium, non-commodity investing–is likely to be the most dynamic and profitable investing in the economy.

Unfortunately for the promise of fiduciary duty to make shareholders into residual beneficiaries, however, a corporation that can determine the time frame in which it maximizes shareholder returns is free never to return anything at all to shareholders.[96] Instead, the corporation may invest for a long term that, like the Red Queen's jam, never arrives:

> "Twopence a week and jam every other day... The rule is, jam tomorrow and jam yesterday, but never jam to-day."[97]

Corporate finance teaches that time frames are irrelevant from the perspective of a diversified shareholder: the financial markets easily allow investors to convert future profits into current ones or vice versa. But inside the corporation, timing is everything: first movers have potential for disequilibrium profits or to create a cascade effect and lasting market domination, while a product that takes too long to develop or that appears

[95]One should not over-exaggerate the necessity of equity investors, however. Other highly successful market economies function quite will with less developed stock markets than ours, finding alternative–often bank-based–sources of long term capital.

[96]Moreover, in the real world, the possibility of market inefficiency is omnipresent. Wall Street, after all, could not exist if the market price were always correct–there would be no reason to research and little cause to trade. For this reason, "the directors of a Delaware corporation have the prerogative to determine that the market undervalues its stock and to protect its stockholders from offers that do not reflect the long-term value of the corporation under its present management plan." *Unitrin*,651 A.2d at 1376. Thus, not only may a board determine to pursue long-term rather than short-term value, but it may also decide that the market's assessment of its plans is simply incorrect. These are not odd doctrinal positions. They are necessary. A corporation exists, as Coase pointed out, because it has some advantage over the market. Coase, supra, n. . If corporations were forced to follow the whims and will of momentary market fluctuations, they would lose that advantage and with it their reason to exist.

[97] LEWIS CARROLL, THROUGH THE LOOKING GLASS, ch V.

before its time, is a product that is likely to fail. Receivables collectible next quarter may be of limited use if payables must be met this quarter: as Long Term Capital Management demonstrated, being right in the long run isn't enough.[98] No legal principle can tell a judge when a company should focus on the next quarter and when it should focus on the next decade.

Interestingly, so long as the stock market believes that dividends are merely deferred, not denied, the stock price should continue to reflect the expected value of future dividends, even if current ones are not being paid. As Miller & Modigliani convinced the investment community a generation ago, current shareholders should be delighted with a company that reinvests internally with an eye to future profit rather than paying dividends– their stock should appreciate by an amount roughly equivalent to the expected value of the dividends they do not receive, giving them the benefit of dividends without the income tax (or the cost to the company).[99]

But, as every procrastinator knows, something that is always better done tomorrow–like paying dividends in a Miller & Modigliani world–is something that will never happen today.[100] Investing for the future, taken to its logical extreme, means never giving anything at all to shareholders. As a practical matter, a corporation's board can evade any requirement that it act in the shareholders' interests by simply declaring that it wishes to use retained earnings for corporate purposes, such as expansion or other plans to improve long term profits, and never declaring dividends at all.[101]

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[98]See generally, ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG TERM CAPITAL MANAGEMENT (2001).

[99]See, supra, fn. .

[100]Cf., Manuel Utset, *A Theory of Self-Control Problems and Incomplete Contracting*, 2003 UTAH L. REV. 1329 (describing procrastination problems).

[101]Louis Lowenstein has made a similar point in connection with Hecla Mining, where, he contends, all the profits from a highly successful mine were reinvested in the mine until the ore ran out–with no payments having been made to the shareholders. LOUIS LOWENSTEIN, SENSE AND NONSENSE IN CORPORATE FINANCE (1991) ch. 7 (describing repeated instances in which managers did not pass on economic profits to shareholders, but instead used them to expand, diversify, etc). Lowenstein presents his examples as instances of managers wasting shareholder money. Courts, he contends, simply do not (I'd contend, could not) police boards that use all economic returns to continue the business as long as possible, thus ensuring that employees, suppliers and customers–but not shareholders–obtain the benefit of the firm's activities. But Lowenstein's condemnation *assumes* that the funds, which legally belong to the corporation, "actually" belong to shareholders. Taking corporate ownership seriously, the issue is, rather, whether corporate managers made proper use of the funds from the inevitably contested perspective of the corporation.

In some cases, it is hard to imagine any perspective from which managers acted successfully – running a great department store into the ground does not seem to in any one's interest. However, in other cases, what looks like waste from the perspective of shares may not have been waste at all from the perspective of other corporate participants. Hecla, for example, as Lowenstein describes it, owned a highly profitable but non-renewable wasting asset–a silver mine. It choose to fully exploit the mine, taking all economic profits and reinvesting them into the mine. In the end, the shareholders received nothing. But employees and silver consumers (if not the environment) did quite a bit better than they might have under an alternative management plan. Contrary to Lowenstein, who sees the managers' decisions as simple self-interested breach of their professional duties, the managers' decision to continue mining as long as possible without paying shareholders was perfectly rational if they were seeking to maximize the profits (or longevity) of the corporation or the mine itself–thought of as an institution with a value of its own–or if they were seeking to maximize employees' continued employment or silver consumers' low-cost silver.

D. The impossibility of fiduciary liability: post-Lochnerism in corporate law

It is conventional to at this point to condemn courts for failing to enforce the shareholder primacy norm. But the courts have not failed. Rather, they have appropriately remained within their institutional constraints in declining an invitation to impose a norm nowhere found in the applicable law and, in any event, unenforceable at any reasonable price. It would be quite difficult and of questionable legitimacy for the courts to police these types of board decisions more carefully.

The law is that boards must operate the company in "the interest of the corporation and its shareholders,"[102] but courts normally are unwilling to second-guess board's decisions as to what those interests might be. The legislatures have been even more agnostic, typically providing that a corporation may be organized for "any legal purpose," not merely to maximize shareholder returns. This is not a surprising result. Even if courts were prepared to force every corporation to adopt a uniform rule of profit maximization notwithstanding the arguments of the previous sections, the realities of the business world would require extreme deference.

We have no professional consensus on how profit is to be maximized. The business schools and business press regularly debate whether, even if one wishes to pursue profit, it isn't better done by placing some other goal–such as customer satisfaction, a great product, or quality service–foremost. Many people believe that profit, like happiness, is best pursued indirectly. Reflecting this, the statutes typically are completely silent on the subject of profit maximization.

Indeed, more broadly, the problem of enforcing fiduciary duty inheres in the basic notions of the liberal state itself.[103] In our post-*Lochner* world, it is hard to imagine courts consistently being anything but deferential to corporate boards. Normally, courts decline to make value judgments or enter into political conflicts unless they have an authoritative norm to which to defer.[104] In ordinary politics, when interests conflict, decisions about whose interests to favor are for the legislature. Similarly, when values conflict, courts seek an authoritative determination of the conflict outside their own decision-making process: judges routinely view themselves as compelled by norms that some other institution has created.

Corporate law is no different. Courts will impose norms only if they are certain that the norm was imposed on the courts by an external authority. In corporate law, however, the courts lack either a social consensus or a legislative mandate for imposing a limited range of purposes on corporations. As noted above, the statutes do not merely allow corporations to determine how best to pursue profit, including indirectly. They explicitly authorize forming corporations for any legal purpose at all. The statutes reflect

[102] *Unocal*, 493 A.2d at 954. The more common formulation follows the RMBCA in omitting "and its shareholders". See supra n. .

[103] See generally on the problem of values in pluralist societies, ROBERTO UNGER, KNOWLEDGE AND POLITICS (1976); MICHAEL SANDEL, DEMOCRACY'S DISCONTENTS (1998).

[104] On patterns of judicial deference, see, *Beyond the Counter-Majoritarian Difficulty*, supra n. .

the social reality: we have no consensus on a single, normative purpose for the corporation. Shareholder primacy may be hegemonic today. But every decade or two, we see a flurry of arguments that corporations in a democracy might actually have purposes or responsibilities beyond making their shareholders rich.[105] And corporations themselves, even the most profit-oriented, assiduously advertise their other virtues and purposes to the general public, offering at least the tribute of hypocrisy to virtue in acknowledging that profit is not, after all, the ultimate end of life.

To be sure, some thinkers have long claimed that something in the nature of the corporation or markets or capitalism itself mandates that corporations be run solely in the interests of shares and that the interests of shares can be understood as a matter of logic without deference to the views of the human shareholders themselves.[106] Courts that have accepted that claim–notably, the *Dodge* and *Revlon* courts–feel freer to coerce boards to act in the manner they deem in the interests of these imaginary shareholders.[107] But in the post-*Lochner* world, property is usually viewed as a creation of the state without a set of inherent rules that can be divined by judges without regard to the statute book.

As we've seen, the statute book simply does not resolve conflicts between shares and other corporate constituencies. Instead it simply creates an internal corporate politics. Under our legislation, the corporate board makes value judgments for the firm. It is the ultimate decision maker only of the technical issue of how to maximize but also of the political issue of what or whether to maximize as well. Courts following the post-*Lochner* paradigm are likely to be inclined to defer to legislative judgments about the extent of property rights and the proper realm of political regulation of our mixed economy and, therefore, to respect the legislative decision that governing the corporation is, within only the broadest of limits, for its board.

Fundamentally, in a liberal society, the interests of articulate adults generally are contested and contestable, and therefore it is usually accepted that they cannot be set out in the abstract without regard to the views of the interested parties themselves. Shareholders are a diverse group–roughly half the American electorate, many foreigners, and institutions representing those individuals in varying roles as well as institutional interests not readily reducible to the interests of their constituents.[108] For courts to impose a single

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105 See, e.g., E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); RALPH NADER, MARK GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION (1976); Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Responsibility*, 112 HARVARD L. REV. 1197 (1999); LAWRENCE MITCHELL, CORPORATE IRRESPONSIBILITY (2001); MARJORIE KELLY, DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY (2001); Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87 (2005).

106 For further discussion, see *Fictional Shareholders*, supra n. .

107 Such courts also see no need to defer to the actual views of shareholders, which–if they differ from the hypothetical interests defined by theorists–are merely evidence of inauthenticity or false consciousness. One clear example is State ex rel. Pillsbury v. Honeywell, Inc., 291 Minn. 322 (1971), in which the court decided that a shareholder who sought to urge the corporation to serve his real interests–by declining to participate in war production on political rather than profit grounds–was not a 'real' shareholder. But the view that corporations exist only to pursue profit, regardless of the views of shareholders or other corporate participants, is quite widespread and has influenced many areas of corporate law. See, *Fictional Shareholders*, supra n. .

108 University endowment funds, for example, represent a set of interests peculiarly difficult to reduce to any individual's. But see, Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEG. STUD. 3 (1990); Henry Hansmann, *Why*

purpose on corporations, they would have to accept a clearly false claim that all these people and organizations have a single interest–maximizing the return on their stock investments at any cost to other human, social, aesthetic, political or ecological values. This flies in the face of ordinary liberal assumptions that people have many ends and many and conflicting goals which they, not judges or economists, ought to resolve or mediate. Courts accepting the idea that a limited government ought not to impose specified ends on its citizenry will be reluctant to impose the share-return maximization goal on corporations or their boards. On this view, it will seem natural to protect the autonomy of internal corporate decision-making mechanisms by deferentially applying the business judgment rule.

In short, corporate law imposes no legal obligation to pay shareholders. While the fiduciary duties of care and loyalty, particularly if seen through the lens of *Dodge*, might seem to impose an equitable obligation to work for shareholders, nearly all observers agree that when combined with the business judgment rule, they provide little restraint on managers. The most common explanation is Judge Winters': that courts defer to boards in order to ensure that managers continue to take risks–that is, that courts are deferring to professional board decisions as to the means the corporation chooses to employ to reach its agreed-upon end.[109] I have argued that deference is even broader–that it extends to the board's choice of ends as well, as most clearly illustrated in *Time*. However, regardless of the motivation for judicial deference, the practical result is clear: in the absence of self-dealing, courts do not police management discretion.[110]

V. Beyond The Simple Economic Models: Lifting Assumptions

As we have seen, our legal rules should generate no dividends for shareholders in competitive markets. Given the complete absence of any legal duty to make distributions to shares and the near absence of any fiduciary or equitable duty to do so, shareholder are sunk costs and payments to them in effect gifts. Competitive product markets bar producers from paying more than marginal costs and leave no funds available for shareholders. Since this is predictable, potential shareholders should decline to invest and the equity market should collapse into a market for lemons.

But equity financing of publicly traded companies actually exists. Accordingly, we need an explanation of how the model differs from the real world.

Capital Hires Labor (suggesting that universities be seen as professor cooperatives). Hansmann's views reflect the common student perception that universities certainly don't exist for their benefit. On the other hand, most faculty members and administrators are likely to find the professor's co-op view at odds with daily experience. Generally, professors do not vote for the board of trustees, and faculty governance ends precisely when the board, or its delegates the administration, disagrees.

[109]See, Joy v. North, 692 F.2d 880 (2d Cir. 1982). Cf. *Eisner* (2005)

[110]See, e.g., Edward Rock, *Preaching to Managers*, 17 J. CORP. L. 605 (1992) ("[Lowenstein's] horror stories [of companies not managed in the interests of their shares] clearly show the limited extent to which either market or institutional or legal mechanisms constrain management discretion"); MARK ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 172 (2002) ("one does not exaggerate much by saying that American corporate law has produced only one major instance in which non-conflicted managers were held liable for mismanagement: Smith v. Van Gorkum").

A. Competitive market solutions–converting fixed costs to variable costs

One way to avoid the sunk cost problem would be to convert fixed costs into variable ones.

To see how this works, return to the physical asset example. If the widget company rents its widget machines on a daily basis, its calculation of when to run them and when not changes. Now it will decide to operate the machine on any given day only if the price it expects to receive for the widgets will cover not only the cost of raw materials and labor but also the rental of the machine. If prices drop below that, the firm will simply close down. For this firm, marginal price (at least on time spans of more than one day) is now equal to average price. If the entire industry were organized in this fashion, the fixed cost problem would be solved and the market would find a competitive equilibrium in which supply, demand, marginal cost and average cost all converge.

For financial capital, the equivalent solution is to substitute debt for equity.[111] If investors fear that they will not be paid for selling their capital to the firm, they can rent it. The equivalent to the daily rental of machinery is short-term or callable loans. If the firm is financed with daily renewable loans, each day the firm must decide whether to continue to pay for funds or whether to close down; accordingly, fees for use of capital are variable costs and will be included in its price. Interest payments, then, are a variable cost.

Moreover, borrowing need not be short-term to solve the investor sunk cost problem. Debtors have a legal right to be paid interest at regular intervals. Since the firm must meet its interest obligations in order to continue to operate, it will treat interest as a variable cost even though it does not vary with production, and it will not be tempted to ignore the cost of debt in calculating its marginal costs.

But the problem is more complicated.

1. Preconditions to the rental solution

First, the debt solution can only work under limited circumstances. If other firms continue to own their capital equipment or finance using equity, they will have lower variable costs and be able to drive a purely debt-financed firm out of business (before driving each other out of business as well).

Even if all firms adopt a rental/debt approach, firms will be tempted to defect–to switch to lower marginal cost ownership and lower, below-average-cost prices in the hope of achieving economies of scale or creating a monopoly. Thus, even using rental of real capital equipment or debt financing may not lead to a stable equilibrium with prices at or above average cost.

For the debt or rental solution work, the market must have some characteristic or restriction preventing other competitors from switching to equity or capital ownership. For example, if rapid technological change means that capital equipment has a very short

[111] Rental of equipment and debt financed purchase are often viewed as economically equivalent, as tax and finance lawyers are well aware.

life-span, fixed costs basically disappear, and lenders should be able to assume that debtor firms will not be competed into bankruptcy.

Alternatively, if potential equity investors are confident that monopoly profits will not appear (e.g., due to strong anti-trust laws), the capital market may simply refuse to provide capital except in the form of loans. This latter scenario may bear some resemblance to the financing of the American railroads or of the post-war Japanese and German economies: in each case, the public capital markets provided largely debt, not equity. If potential equity investors are clearly aware that equity financing would be a losing game, potential debt investors can invest without worrying about being undercut by equity-financed predators.

2. Is it turtles all the way down?

Second, it may seem that shifting to rental, even if successful, simply pushes the sunk cost problem back one level. If railroads all rented their rails, they might not be tempted to compete prices below average cost. But the owners of the rails would. Each rail owner would prefer to rent at any price above its marginal cost for renting – essentially zero – rather than let the rails sit unused. Thus, rail owners will bid down the cost of rentals to their marginal cost, replicating the original problem. As William James said, it's turtles all the way down. The market should collapse or gyrate from boom to bust, because ex ante, foreseeing the sunk cost problem, no one would enter the rail business in the first place without seeing some escape from competitive pricing.

Here, however, financial capital does not work the same way as real capital assets. The sunk costs problem appears when the marginal cost (not including sunk costs) of using an existing physical asset is lower than the average cost. Equity capital replicates that problem because once an investor purchases stock from a company, the company has the right to use those funds with no legally mandated further payments to the investor. But financial capital in general does not replicate the sunk cost problem.

The cost of using a highly fungible asset–and money is the most fungible of all assets–includes Coasian opportunity costs: the money that could be made by using it in an alternative investment. Investors can sell or rent their cash to many different businesses, not all of which will be afflicted with the sunk cost problem. Accordingly, lenders, who can readily shift their funds to other uses, will not be susceptible to the sunk cost problems of renters of railroad tracks, who are stuck with tracks that have no ready alternative use. If railroads wish to borrow, they will have to pay the going rate for finance capital, and if loans are short term, they will have to pay it on a current basis with no difference between ex ante and ex post calculations.

So far, then, we come to this odd conclusion. Firms selling their product in efficient commodities markets should treat equity capital as a sunk cost and not include it in prices, which will be set at marginal cost. Whether or not the stock is "entitled" to the residual, it has no reasonable expectation of actually receiving any payment at all: not only no residual but not even the ordinary cost of capital.

Since this ex post defection is entirely predictable ex ante, rational investors will expect to receive no compensation for their purchase of equity in such firms and will not purchase it. On the other hand, if finance capital is supplied in the form of debt, firms will be forced to include its cost in their prices and therefore (assuming other firms do the same) to recover its costs from consumers. The result should be that firms in efficient commodities markets are entirely debt financed. Once again, the model suggests the original puzzle: why does equity financing exist at all?

B. Escaping the equity capital sunk cost trap through leveraged buyouts

For a moment in the 1980s, prominent theorists declared the public corporation dead, for reasons that partly fit this analysis.[112] The world, Jensen said, belonged to management-led leveraged buy-outs (LBOs). In these transactions, equity is replaced by debt. Firms borrowed money in order to buy back their stock, resulting in a firm financed mainly with debt. The small amount of equity left generally was held in large part by managers who had contributed little or no actual capital to the firm. As a result of replacing equity with debt, interest payments would rise and the firm's legal profit would drop sharply.

Reduced profit might seem bad, but the relevant players thought otherwise. The basic notion was that the new interest payments were simply a reclassification of the old dividend payments–a different name for the same return to capital.

Re-labeling profits as interest had a series of advantages, not all of them explicitly set out by Jensen. For our purposes, the most important is that debt capital is rented, not contributed; it is an ongoing, not a sunk, cost. Since bondholders have a legal right to returns, the marginal cost of debt is not zero, but rather the contractually mandated interest rate (discounted by the firm's ability to renegotiate contracts in bankruptcy). Accordingly, capital can expect to earn a normal return and the sunk cost trap problem is solved.

Moreover, if the firm is able to generate surplus, changing dividends into interest changes the frame in which conflict over corporate surplus takes place. A corporation that creates a surplus must allocate it in some fashion between consumers, capital, labor and other factors of production. The change from equity to debt capitalization does not change this fundamental reality, but it radically shifts the appearance of the conflict.

When a successful firm is financed by equity capital, its surplus is labeled profits. The firm appears rich. It then decides whether to allocate its wealth to shareholders (in the form of dividends) or employees (in the form of pay increases) or other corporate constituents. The direct conflict is transparent and obvious: every penny that goes to dividends is a penny that does not go to employee profit sharing or consumer rebates. Employees can be expected to be highly resentful if they do not share in the surplus; it is hard to frame a morally acceptable reason why the success of the team should go only to one part of the players.

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[112] See, e.g., Michael C. Jensen, *The Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989.

In contrast, the leveraged firm transforms wealth into poverty, profits into loss and voluntary gifts to capital into unavoidable necessity. When the surplus is created, the debt capital already has a claim on it. In a debt-financed firm, the allocation of surplus is done ex ante, before the surplus is created, at the time when debt is issued, contracts are negotiated and prices are set. The direct conflict between capital, consumers and labor over the surplus is likely to be less salient at this point. Indeed, it may be entirely invisible. The only way for an observer to determine where the surplus is going, or even whether there is a surplus, is to create a second set of accounting records for the firm in which the actual contractual prices are replaced with hypothetical market prices reflecting the minimum the firm could have paid to obtain the resources it needs. But that is likely to be highly controversial: How can we ever know what different bargaining might have achieved?

Consider the most extreme example, where the firm seeks to allocate the entire surplus to capital. With conventional financing, this requires simultaneously pressing hard on labor and paying obviously high dividends out of highly visible profits. Since the equity market is quite competitive, high dividends will result in high stock prices. Employees, then, see harsh bargaining on wages, high accounting profits, large dividends and increasing stock prices: surely a recipe for labor unrest. Relatively few people like being squeezed to make the rich richer, recent election returns notwithstanding.

The highly leveraged firm, however, looks quite different. To allocate all surplus to capital, this firm issues debt with large interest obligations–obligations that can only be met if the firm is quite successful. There is no easy way for employees or other observers to distinguish between the part of the promised interest payments that is a necessary market payment to obtain capital and the part that is a promise to distribute future surplus, if any, to capital. Now, even if the firm is generating the same economic surplus as before, it will no longer show accounting profits. Instead, given ordinary variation in business success, the firm will frequently generate accounting losses. Ex post, employees will see a firm in crisis, insolvency a real possibility, low or no dividends and (if the stock remains publicly traded) poor and highly variable stock market performance. Even if the underlying economic reality continues to be that the firm creates a disequilbrium surplus, employees are likely to see demands for pay increases from this firm as greedy and even counterproductive–it is in no one's interest to force your employer into bankruptcy.

Employees who might be disinclined to accept a smaller share of the corporate pie in order to increase "profits" for distribution to shareholders are likely to be far less obdurate in the face of demands that they sacrifice to prevent "default" and "bankruptcy" that will result if interest is not paid. Contributing your share towards collective survival feels good–quite different from being squeezed to make higher profits for investors. In short, by the simple expedient of setting high interest rates, the firm can guarantee that it would always be in crisis and thus always be able to call on employees to make extra sacrifice for the team, to avoid the disaster of collapse, rather than making the less attractive claim that employees ought to accept less so that investors can profit more.[113]

At the same time, eliminating legal "profit" eliminates corporate income tax obligations. Thus, reclassifying capital investors from equity (shareholders) to debt (bondholders) solves the sunk cost problem and simultaneously allows transfer to capital investors of rents to that formerly went to employees and the citizenry generally (as taxes or price cuts).

Moreover, if managers hold substantial stakes in whatever equity is left, the LBO may solve another part of the returns-to-equity puzzle. Dividends remain discretionary, and continue to be a cost that a firm in competitive equilibrium cannot sustain. But if the firm is able to earn economic profits–that is, to charge a price above its marginal costs–now there is some reason to think that those disequilibrium rents will go to shareholders. When managers are shareholders, they may find that by helping shareholders they are helping themselves.[114]

Finally, bankruptcy law, unlike general corporate law, creates an enforceable fiduciary obligation to run the company on behalf of creditors, in order of preference. If the firm does end up in court-supervised reorganization, the courts are likely to assist the firm in further transfers from labor to capital. While no firm is ever entitled to breach an employee contract in order to pay a dividend, bankruptcy courts routinely relieve firms of their obligations to pay employees in order to pay interest. Indeed, not only will bankruptcy courts allow firms to reject their contractual obligations to pay for future labor, they will allow them to renege on pension and related promises to pay for labor that employees have already performed. It would be inconceivable for a firm to publicly state that it was reneging on pension promises because it wished to make high dividends higher. But it is routine to do the same thing to fulfill economically equivalent interest obligations–even if the obligations were assumed knowing they likely could not be met without defaulting on promises to employees.

The LBO, then, is one possible solution to the sunk cost trap. It transforms equity into debt, changing capital from zero-marginal cost to a high marginal cost, from no legal

[113]See, Daniel JH Greenwood, *Team Spirit: Doing Bad Things in the Cause of Good*, in WILLIAM A. MYERS (ED.), THE RANGES OF EVIL: MULTIDISCIPLINARY STUDIES IN HUMAN WICKEDNESS (INTERDISCIPLINARY PRESS, 2006); Margaret Blair and Lynn Stout, *A Team Production Theory of Corporation Law*, 85 VA. L. REV. 247 (1999).

[114]If managers are not the only shareholders, however, we still need some explanation why managers would choose to share firm rents with other shareholders rather than simply increasing their salaries to absorb the excess. Of course, managers *have* increased their pay to astonishing levels. However, I think it clear that the LBO movement recognized a genuine political truth–while money may be fungible, salary and dividends are quite different. High pay is inherently more offensive than high returns to capital. High salary at a certain point invites questioning about whether anyone's efforts could be worth that much more than the rest of us. In contrast, returns to capital do not imply anything about the moral qualities or hard work of the recipient relative to others. Consequently, there is something necessarily unseemly about someone receiving pay hundreds of times higher than fellow workers, but there is nothing odd about an owner receiving profits. When Michael Milken choose to tie his salary to the profits of the company he built, he became the highest paid employee in the country and a national scandal. In contrast, when Ross Perot or Bill Gates choose relatively small salaries accompanied by ownership interests, they not only appropriated more of their firm's wealth, they also became heros.

right to payment to high priority, from weak moral claims to strong ones. The net result should be an increased part of the corporate pie going to capital.

Had the LBO taken over the world, we would be able to say confidently that equity capital suffers from a serious sunk cost problem precisely analogous to that of the railroads. However, we do see companies that are able to sell equity, so there must be other ways out of the sunk cost pricing trap.

C. Market irrationality

One possibility is that stock investors are not rational. Perhaps, Charlie Brown-like, they continually expect that this time will be different and are doomed to disappointment. For example, investors may routinely expect companies to overcome the fixed cost problem through monopoly power. A certain number of companies will, of course, achieve pricing power for some period of time, leading to spectacular economic profits. Cognitive errors, such as the greater salience of success over failure or dramatic over routine results, might lead investors to miscalculate the actual odds of success.[115]

The possibility that the equity market exists only because of irrationality should not be dismissed outright. Even devotees of rational market theories acknowledge that certain aspects of market pricing seem irrational. Perhaps the best known problem is the initial public offering of close-end funds.

1. The IPO Puzzle

Closed end mutual funds consisting of a package of publicly traded stock routinely trade in the secondary market at a *discount* to the value of the underlying assets taken separately (net asset value).[116] In contrast, initial public offerings of such funds are always sold at a *premium* to the net asset value, because that premium is how the promoters are paid. It would seem to be somewhat irrational to pay a premium for a package that one could construct for oneself for minimal cost, and entirely irrational to pay that premium knowing that odds are high that the package itself will soon be available at a discount. Why pay a mark-up today when you know the product will be on sale next week? Often the market is rational and no new closed end funds are issued. But closed end funds exist, which must mean that at least sometimes irrational investors are available to purchase them in IPOs.

Investing in the initial public offering of an ordinary corporation is almost as hard to understand. To be sure, ordinary corporations are less transparent, so it is harder to tell that IPO investors are routinely overpaying. Still, there are several bases for thinking the closed-end mutual fund story is generalizable.

First, strong statistical evidence suggests that IPOs, as a group, lose money for their initial investors, especially over the medium term. That is, if you have determined that you wish to own stock of the company in question, you are generally better off waiting until after the IPO and the initial price pop that promoters attempt to create have passed.

[115]See generally, Kahneman & Tversky

[116]See, Reiner Kraakman, *Taking Discounts Seriously*, 88 COLUM. L. REV. 891 (1988).

This statistical result is not surprising: the decision to offer stock to the public is made by insiders in the company who normally are, or represent, both incumbent management and the pre-IPO shareholders. It is hard to understand why those insiders would choose to sell their control and/or stock unless they thought they were getting a good price.[117] But a good price for the insiders is a bad price for IPO purchasers. Accordingly, an investor buying stock in an IPO is, in effect, betting that the insiders are wrong. This, in turn, seems to suggest that the investor has concluded that the insiders are either incompetent or uninformed relative to the investor. In either case, it is surely irrational to give them money to invest.

Alternatively, the investor may have concluded that whether or not the IPO is priced correctly, other outside investors will be willing to overpay even more. Oddly, this might even be correct – leading to a situation in which even rational investors may be willing to sell their capital to the company (by purchasing stock) at prices that cannot be rationally defended. I'd happily buy your worthless paper for $5 if I'm quite confident that someone else will quickly buy it from me for $10.[118]

2. A sucker a minute keeps the market healthy, wealthy and wise

So one, depressing, explanation for why the stock market exists might be straight P.T. Barnum: a sucker is born every minute. On this view, the sunk cost model correctly describes the analysis of rational investors in a market of rational investors. But if there are enough irrational investors who don't understand that they don't have any reasonable expectation of the company paying for the money they give it, the market can continue. Rational investors will buy in the expectation of selling to irrational investors, who will expect–baselessly–to share in economic profits the company is unlikely ever to make. Occasional firms will defy the odds, thus confirming the irrational investors in their biased preconceptions. More often, the stock will be merrily sold back and forth in the secondary market without any rational basis until, in the end, some sucker ends up holding it when it becomes apparent to all that it is worthless.

But all this is unsatisfying. Many publicly traded companies do appear to earn economic profits and do pay dividends. Retrospective investigations of stock prices generally can rationally justify them using expectations of future dividends that–even if often overly optimistic–do not seem to be wildly different from the actual event. Even if the financial markets as we know them are heavily dependent on irrationality, it seems hard to believe that irrationality is the whole explanation.

D. Pricing power: firms with surplus to distribute

A different possibility is that competitive commodity markets are anomalous, that most publicly traded companies do have pricing power and are able to charge (at least) average price even when marginal price (not including sunk costs, including the cost of

[117]Even if insiders needed cash, if they were confident that the company and/or stock price was likely to rise, they would borrow rather than sell equity.

[118]On rational arbitrage creating even more irrational pricing, see ...

equity capital) is lower. This explanation fits nicely with Warren Buffett's investment advice–invest in companies that sell unique products and therefore have pricing power.

A firm with monopoly power, or which is able to create a temporary disequilibrium by innovation, may be able to price its products above the cost of the inputs and thus earn economic rents or profit. For current purposes, the source of the pricing power is not important; all that matters is that in this circumstance, unlike the fully competitive market explored above, the firm has a residual to be distributed.

This is the profit to which shareholders are said to have a right. But the fact that the consumer market is less competitive changes none of the above analysis. The corporation still has no legal obligation to pay its residual to the shares. A corporation that treats its shareholders as a factor of production like all others still has no reason to pay shareholders any more than the marginal cost of their contribution. And the marginal cost of a factor of production that is fully committed and can not be withdrawn from the firm is still zero. Even if the firm might wish to obtain additional equity capital, there is no reason to pay more for it than the average cost of money on the market–money is a fully fungible commodity.

In short, even a firm with economic profits has no reason to distribute rents to shareholders, and shareholders have no obvious legal or market ability to force it to do so. So long as the finance markets are competitive, the key issue for shareholders is why they should expect to be paid anything at all, not any putative entitlement to payment above their average cost or average product.

E. The power of the "market for corporate control"

Rather than a legal *right* to the surplus, perhaps shareholders just have the raw *power* to take it.

The shareholders' relationship to the corporation is basically political. They are not owners, contracting parties, trust beneficiaries, or principals, despite the widespread popularity of such metaphors among ideological defenders of the investor role.[119] Owners, of course, do not have to offer justifications for why they should be entitled to take any surplus associated with their property. Owners just take it as an aspect of their general rights to control the property.[120] If someone prevents them from doing so, they can invoke the judicial process and police to deliver it to them. Shareholders, unlike owners, have no legal right to control the corporation and specifically no right to demand that the corporation turn over corporate property–whether surplus or not–to shareholders. Similarly, shareholders lack enforceable contractual rights; lack the legal protections of

[119]For preliminary discussions of the metaphors of corporate law, see Daniel JH Greenwood, *Markets & Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41 (2005), part IB; *Enronitis*, supra n. , at parts IV.A.1-2, IV.B.3; *Introduction to the Metaphors of Corporate Law*, 4 SEATTLE J. SOC. JUSTICE 1 (2006).

[120]Brearly & Myers, for example, state that "a corporation is owned by its common shareholders." BREARLY & MYERS, supra n. at 366. They explain this claim by stating that in a corporation with a single shareholder who is also the CEO and no debt, the shareholder would have "complete cash-flow" and "complete control" rights. The former is clearly incorrect, if the corporation has other contracting parties, such as employees or suppliers. In any event, they then simply assert that the shareholders of a public corporation have the same "ultimate" rights as a single shareholder. Id. at 368. This assertion appears to ignore the realities of fiduciary law and board autonomy.

trust beneficiaries; and, quite unlike principals in an agency relationship, they have no right to direct or terminate directors and are not bound by their actions.

Instead, the shareholders are electors. Shares have the right to vote for the directors who do have legal rights of control over the firm. Unlike shareholders, the board of directors is entitled to control over the corporation's property (although only for appropriate purposes: the directors are not owners either). Perhaps the political rights of shares create indirect control sufficient to ensure that shareholders will receive the surplus. This in turn would suggest that we should see them as simple rent-seekers in the mode of standard public choice models, using their power in the (corporate) political process to obtain benefits (by corporate administrative decree) that they could not win under standard competitive market conditions.

Clearly, the shares sometimes do have the ability to force the corporation to distribute its assets to them.

1. Corporations with a single shareholder: quasi-ownership, political control

Consider the simplest case, a corporation with only a single shareholder.

A single shareholder has almost the standard bundle of ownership rights with respect to the corporation. Corporate law insists that the corporation remain separate from the shareholder. Still, so long as the shareholder works within the formal procedures of corporate law, it is largely free to determine whether assets remain in the firm or exit it and to whom.[121] While the directors are still in formal control of the firm, with the associated fiduciary duties of independent judgment, loyalty and care, a sole shareholder controls their tenure and can readily replace any director whose independent judgment fails to match the shareholder's. Moreover, only shareholders have standing to enforce the fiduciary duties, so those duties do not limit a sole shareholder. Accordingly, the sole shareholder has indirect but effective control of the decision making apparatus of the firm. In the medium run, the shareholder's will determines what will happen, not board judgments about shareholder interests or legal doctrines of due care, loyalty or corporate purpose. With a single shareholder, the corporation's separate existence becomes a legal fiction and the shareholder, formally merely an elector, is almost a real owner.

Here, if the firm has market power to create a producer's surplus, the surplus is (almost) the shareholder's. It will go to other firm participants only if the shareholder decides to give it to them. We do not need any account of the "right" of the shareholder or the "purpose" of the firm to reach this result. As a matter of law, that surplus belongs to the firm, and the shareholder decides what the firm will do with it. Presumably, self-interested shareholders will take it for themselves, although for tax reasons generally not in their role as shareholder.

Of course, political right is not market power.

If other firm participants have sufficient market power, they are likely to demand and receive part or all of the returns to cooperation reflected in a producer's surplus. Once

[121]Corporate law limits are not entirely procedural. The Fraudulent Conveyance Acts and dividend restrictions will limit the ability of single shareholders of corporations near insolvency to remove corporate assets.

other firms imitate the efficiencies of this one, the surplus will go to consumers, as prices are bid down to costs. If other producers do not appear, but factors in this firm are able to make themselves expensive to replace–skilled employees, for example–those factors will charge the firm more, and the surplus will go to them. It is a question of relative market power whether the gains created by cooperation will become firm residual.

The shareholder's political control, in short, gives it power over the residual, not the surplus. But that entitlement is somewhat tautologous. The residual is simply whatever is left in the corporation at the end of a struggle with everyone else over the surplus to cooperation. If the entire surplus goes to some other corporate participant, the shareholder may be disappointed, but has no cause to complain of unfairness or illegitimacy. In a capitalist system, no one has a right to rents–only a right to struggle with other rent seekers over them until, hopefully, competition eliminates them entirely.

2. Closely held corporations

Even when a single shareholder (or a small group of shareholders legally permitted to coordinate) controls only a majority of the shares, that control is enough to give the shareholder significant power. The distinction between shareholder role and director role becomes largely irrelevant when a single shareholder controls a majority of the stock and its associated votes. At that point, the shareholder has the legal right to elect the board of directors and therefore can control their decisions within the broad constraints of the business judgment rule.

To be sure, such a majority shareholder still does not have all the rights of ownership. Courts continue to insist that the directors exercise independent judgment and, in particular, that they not unduly favor the interests of the majority shareholder over the (imagined) interests of other shares. But in practice, judicial supervision may be limited enough that the controlling shareholder is close enough to that of a sole shareholder, particularly in conflicts with non-shareholders.

3. Public corporations: the right to go private

Shareholders in public corporation have one important source of power that we have not discussed: the ability to sell to a single shareholder who will take the company private.

More precisely, the entire stock market has this power, because it is the entire stock market that determines stock price.[122] If the investment community decides that a company is not being run in the interests of shareholders (or sufficiently in their interest), potential purchasers will lower the amount they are willing to pay for its stock, and potential sellers will only be able to sell at a reduced price. The stock price drops. Critically, this is not an action of the existing shareholders, but of the market as a whole.

If the stock price drops enough, competitors or investors will see a profit opportunity: if they can purchase all the stock, they will be able to use the quasi-ownership rights of a single shareholder to change the distribution of the company's economic profits.

[122] For a fuller discussion, see *Fictional Shareholders*, supra n.

i. The brief heyday of stock market control

For a brief moment in the 1980s, this was the end of the story. Once an opportunity was spotted, someone seized it, and the company was forced to change. The stock market always won.[123]

When a tempting target presented itself–often a conglomerate or heavily unionized company that obviously was generating surplus and distributing it to constituents other than the shareholders–junk bond financed financial operators or strategic investors smelling a bargain would launch a tender offer, sometimes in combination with a proxy contest to replace the incumbent board. Often, the tender price could be dramatically higher than the current market price of publicly traded stock, precisely because the offeror's valuation would reflect the greater power of a single shareholder while the public price reflected the reality that public shareholders have no power to force managers to run the company in their interest.[124]

If the offer price was higher than the market's estimate of the value of the company's public stock under existing policies, the stock price usually rose immediately to match, as pessimistic or backwards looking shareholders sold to professional arbitrageurs whose profits depended on a quick sale of the company. The new shareholders, in turn, would quickly sell into a tender offer, and control of the company would move to a single shareholder. Sometimes, particularly in the early 1980s, potential buyers could make success even more likely, by structuring the offer to provide a prisoner's dilemma in which shareholders would be tempted to race to tender even at unattractive prices lest others tender first and leave them holding an even less attractive package. In any event, after a successful tender offer, the buyer then ended up with all the stock, and could appropriate the firm's surplus as a quasi-owner of a closely-held corporation.

In the world of the ever-present hostile takeover threat, the stock market had real power. Managers quickly learned that running the company as the stock market preferred was their only choice; anything else threatened instant removal through hostile tender offers. Managers who remained loyal to their subordinates in middle management and the blue collar ranks found themselves removed.

The pain of powerlessness was lessened once it became clear that the stock market was happy to see managers take unprecedentedly large shares of the corporate surplus for themselves, so long as they did it in a way that appeared to tie their interests to those of shareholders. Managers, thus, faced a choice of maintaining their old loyalties and ways of operation and being displaced by someone who would violate the implicit agreements and norms of the prior era.[125] Alternatively, they could do the betrayals themselves and assuage their guilt with a large chunk of the wealth transferred from other corporate participants. In the middle 1980s, defensive advisors often had to pull their clients along

[123]The literature on the active market for corporate control of the 1980s is enormous. A good starting point might be, e.g., John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 MICH. L. REV. 1 (1986).

[124]See, e.g., Reiner Kraakman, *Taking Discounts Seriously*, 88 Col. L. Rev. 891 (1988).

[125]See, Coffee, supra n. .

into this brave new world kicking and screaming: for many, when loyalty and professional ethics conflicted with economic self-interest, the choice was not clear.

By the 1990s, the culture of America's board rooms had changed to the point where this Faustian bargain no longer seemed clearly immoral. The new generation of CEOs celebrated market norms of self-interest, gave themselves enough stock or options to become shareholders on a level not seen since the company founders of the gilded age, and made profit and high stock price key corporate goals. The stock market applauded. From the market's perspective, one CEO, even if he was becoming rich beyond imagination, could not take as much of the corporate surplus as the entire workforce. Shareholding managers, the market correctly understood, would be far more likely to see returns to shares as a key corporate purpose. Moreover, as CEOs moved out of the professional classes into the ranks of the super-rich, they could be expected to find the share-centered view of the world increasingly consonant with their daily lives: the new plutocrats have more in common with the rentier class than the subordinates with whom they work every day.

Still, however, even as the new CEOs accepted the profits of their new alliance with the stock market, they proved no more loyal to shareholders than they had to their co-workers.

ii. Return to normalcy: the poison pill and the new politics of corporate control

The stock market's power was quickly quashed. It turned out that a robust take-over market had few supporters outside of the corporate law academy. By the early 1990s, the courts and legislatures had assiduously approved new rules that shifted power back to the board. The key one is the poison pill and its statutory equivalents, which effectively bar the shareholders from selling to a single shareholder without the consent of the board.[126] Virtually every publicly traded corporation has taken advantage of these developments to eliminate the anomalous right of shareholder initiative that made the hostile takeover possible. Today, the shareholders have no more legal power to sell the company to a single shareholder than they have to act for the corporation in any other way. To buy a publicly traded corporation and take it private, you must obtain board approval. Moreover, the courts, as we saw in the *Time* case, are quite reluctant to force boards to endorse particular transactions or to remove barriers to it, so in the end, the question is whether the market can persuade the board to see things its way.

Interestingly, boards continue to approve uninvited takeover attempts. Rarely, however, is it fair to say that boards are forced to do so. Shareholders simply lack the power to force boards to do their bidding. Only shares vote in the corporation, so shareholders have a certain advantage in political struggles to dominate the board. But board elections are normally unopposed. Even when they are contested, the incumbents

[126] The poison pill drastically dilutes the holdings of any offeror who proceeds without board permission. Parallel statutory provisions bar "interested shareholders" from merging with the company for prohibitively long periods if they acquire controlling positions without prior board consent. See, e.g., Del. Gen. Bus. Code § 203 (barring interested shareholder from merging for 3 years absent prior board consent or supermajority share approval at a shareholder's meeting).

have enormous advantages, including the right to use corporate resources to defend their positions. Corporate elections more often look like elections in Saddam Hussein's Iraq, with dissidence apparently absent, then like the hard fought conflicts of real democracy or the sharply divided "Red-Blue" contests of the rest of American society.[127]

Moreover, as we've seen, shareholders have no right to instruct the board; they must, instead, elect directors who independently conclude that the company should be sold. But shareholders have no right to replace board members except at the end of their term and at a shareholders meeting.[128] Generally, shareholders, even an overwhelming majority, have no right to call a special meeting, and regularly scheduled meetings occur only once a year.[129] Moreover, many firms have staggered boards, where each director has a three year term and only one-third of the board is elected each year.[130] As a result, as a matter of raw power, even a board with no shareholder support at all can usually hang on for quite a while.

Potential buyers, in contrast, usually cannot keep their offers open indefinitely. Financial buyers, planning not to run the company but simply to buy it at a price reflecting the current, shareholder-unfriendly, policies; to change those policies to give more of the surplus to shareholders; and then return the company to the public markets at a higher valuation or sell it to a strategic investor, operate in the financial markets and therefore are painfully aware of the time value of money. Whether they are operating on borrowed money and therefore running up interest costs, or with equity and therefore suffering opportunity costs as their funds remain un-invested, they typically cannot simply hang around waiting for directors to be replaced. Strategic buyers are no more likely to wait extended periods. They have businesses to run. In consolidating industries, alternative deals may disappear; businesses feel a great deal of pressure to either get the deal done or move on to another one. Defensive strategists know, therefore, that a board that is willing to fight with all the tools available to it generally can delay a potential transaction until it dies.

The market for corporate control, in short, is no longer an adequate explanation for why shareholders should receive any of the corporate surplus. With the demise of tender offers that could be consummated without board approval, the stock market lacks a legal means to impose its will on directors and managers. Under current law and practice, shareholders have no legal right to sell to a single shareholder. The potential buyer must

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[127] I've discussed the reasons for this near unanimity and its implications for the metaphor of "corporate democracy" in *Fictional Shareholders*, supra n. . For further discussion of the mechanisms of political democracy in corporate and non-corporate contexts, see *Beyond the Counter-Majoritarian Difficulty*, supra n. (discussing the varieties of political decisionmaking); Daniel J.H. Greenwood, *Akhnai*, 1997 UTAH L. REV. 309 (discussing paradoxes of majority rule).

[128] Del. Gen. Corp. Code §141 (b) (providing that directors serve until successor is qualified); (k) providing that majority of share votes may remove a director, except that corporations may, by adopting classified board or cumulative voting, prevent removal of director without cause before the end of his term); 211 (b) (providing that election of board of directors is at the annual shareholders meeting).

[129] Del. Gen. Corp. Code § 211 (d) (authorizing directors to call special meeting and allowing corporation to bar shareholders from doing so). Delaware law permits corporations to bar shareholders from electing directors by written consent in lieu of a meeting. 211 (b).

[130] Del. Gen. Corp. Code §141 (b), (d) (authorizing staggered board).

follow the stringent requirements of the Federal regulatory scheme in order to make a tender offer. Incumbent managers and directors, should they oppose the plan, are entitled to use company resources to resist it in every legal fashion. Most importantly, if the company has a poison pill in place, as most do, a potential buyer usually will find the transaction financially impossible unless the board allows it to go forward by voting to redeem the pill.

4. The limits of power

In the end, both the political and the market power of public shareholders are quite limited. Any given shareholder is purely fungible, readily replaceable by another money source. Even collectively, the entire stock market has only the power to drive the stock price down. Low stock prices may be unattractive to managers in their personal capacity if they hold stock or stock options themselves. High stock prices, in contrast, provide the company a ready currency with which to purchase other companies, which may be attractive to managers both as professionals and as status- or power-seeking individuals. But these carrots and sticks have their limits; directors or managers with other values or other goals than stock price maximization should be able to resist them.

Most politics is by informal persuasion, in the shadow of the power of the electorate, donors, masses, violence, organization, guns or wealth. In public corporations shares have votes, but shareholders lack the other sources of political power. They are anonymous, transient, unorganized and fungible. As we've seen, generally they can not call on the power of the state or the market to support them.

Beyond the thin shadow of their limited power, the shareholders lack even full mechanisms of informal persuasion. They have only the weakest of connections with the actual sociological entity of the firm. The human beings who act for the firm–the employees–have actual relationships with each other, but not with shareholders. In most cases, directors are likely to respond to each other and especially to top management–the actual people they actually talk to on a daily basis. The power of real, human, shareholders (or, more often, human representatives of institutional shareholders) to influence this conversation is quite limited.

D. Cynics and Ideologues: Self-Interested Managers and The Metaphors of Corporate Law

Why then do boards agree? Even more importantly, why do companies pay dividends to their shareholders, buy back their stock or otherwise distribute any of their economic profits to shareholders?

As we have seen, neither economics, legal rights nor raw power provide the answer. Public shareholders are not owners who can simply take surplus and depend on the power of the state to stand behind them if anyone tries to stop them. They have neither market power nor political power sufficient to force the company to give the surplus to them.

1. Atavistic irrationality

Only a few explanations are left. Perhaps the boards are irrationally unaware of their power. The hostile takeovers of the 1980s were a traumatic experience; maybe boards are still afraid of a repeat even though the law no longer allows it. This would be surprising, however, since boards are typically well advised, and the power of the defensive tactics is no secret.

2. Tag-along behind powerful managers

More likely, boards are responding to the very real power of top management, and top management has concluded that paying dividends and otherwise acting to keep the stock price up is in its own (as opposed to the corporation's). Cynically, simplistic, unprofessional and uninteresting as this explanation is, it must be a major part of the truth. The great revolution of the 1980s ended with top managers holding a major part of the stock of our major public corporations. Since then we have discovered the obvious–that managers who are invited to pursue their own self-interest will do so, and that self-interest will often drive them in directions that are not in the interests of shareholders or any other corporate participant.[131] Still, when a manager holds millions of dollars of stock or stock options, he is likely to find the claims of stock to a share of the corporate pie more persuasive, and the claims of ordinary employees (now so much poorer as to be in almost a different world) less so.

The great secret of the great manager/shareholder conflict that is at the heart of corporate law is that, conflicts notwithstanding, managers and shareholders have united to shift the corporate surplus from all the other corporate participants. Only then do the arguments over the spoil begin. The basic protection shareholders have is the basic legal principle that all shares must be treated equally when a dividend is declared and the assumption that managers will, in the end, want to issue dividends both as an efficient way to extract larger sums from the corporation than they can award themselves in direct salary and in order to maintain the value of the stock that managers hold. That said, for all the reasons discussed above, when managers determine that their interests are no longer aligned with the other shareholders, there is not a whole lot the outside shareholders can do about it.[132]

To the extent, then, that shareholder returns depend on power, the power is managerial power. So long as managers do not discover a way to compensate themselves without compensating shareholders as well, shareholders will continue to receive returns. Shareholders, then, are not entitled to the residual. They do not have the legal power to take it. They do not create it. They do not have market power to demand it. They just have had the good fortune to receive part of it as a side-effect of managerial self-enrichment. Presumably, this is a short term game. Sooner or later top managers, now extraordinarily wealthy as well as positionally powerful, will figure out a more efficient

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[131]See, e.g., *Enronitis*, supra n. (discussing reasons why managers might defect from their fundamental alliance with shareholders).
[132]Id.

way to distribute corporate surplus to themselves without leaving so much of it for purely fungible providers of a fixed cost.[133]

3. The power of words

The last explanation is ideology. If they are not simply being dragged along by managers who have not yet figured out how to personally profit without giving to shareholders as well, the shareholders must depend on directors concluding that the shareholders' claim to the surplus is just and right. If directors are persuaded that shareholders ought to be treated as if they were owners, or trust beneficiaries, or principals, or contractual insurers with an inexplicably favorable deal, they may choose to give shareholders firm assets or give in when the shareholders attempt to rebel.

The metaphors of ownership, agency, trust, contract and property rights are pervasive in corporate law discourse and management training alike.[134] As we have seen, these metaphors are not accurate descriptions of the legal relationships between shareholders and other corporate actors. Instead, they function to hide the market reality that equity capital would have difficulty commanding any return at all in anything resembling a free, competitive market.

a. The problem of managers as fiduciaries

The rule is clear that directors and CEOs are fiduciaries, not owners. They run the company, but they must do so as professionals, in the interests of their client, not for their own benefit. In this respect, they are like elected officials and civil servants, who also run large institutions for the benefit of the general public without "owning" them; they similarly resemble all employees in the private sector, who, by the norms of agency law, are supposed to work for the interests of their employers, not themselves, and have no ownership rights in the products they create or the positions they hold. A director or CEO who operates the company in his own private interest is as clearly corrupt as a governmental official who diverts public assets to become privately wealthy or a professional who misuses client trust for personal gain.

But the client of the directors and the CEO is the firm itself, and that creates room for creative ambiguity. If it is clear that the board may not enrich itself at the corporation's expense,[135] it is far less clear what it means to work for "the corporation."

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[133]As one would expect, we have seen a number of instance in which CEOs have paid themselves vast sums while the shareholders received nothing. [Assorted scandal companies - Enron, Tyco – and Fortune's hall of shame of unsuccessful ones (Delta, AOL). As companies correct for the accounting fiction that stock options have no effect on reported profits, we are likely to see more instances where it is clear that in fact the entire corporate surplus went to the CEO and accounting profits suggesting shareholder returns were illusory. [Article claiming that Microsoft restated has no accounting profis].

[134]See supra, fn. .

[135]The duty of loyalty clearly bars corporate fiduciaries from promoting their own interests at the expense of the corporation's. Corporate law's duty of loyalty is, however, quite a bit weaker than the equivalent duties in trust law or governmental civil service norms: Nepotism, conflicts of interest, and even what Boss Tweed defended as "clean graft" are typically permitted in the corporate sector, at least with adequate disclosure and approval by disinterested parties. Bayer v. Beran, 49 N.Y.S. 2d 2 (Sup. Ct. 1944) (allowing corporation to hire CEO's spouse so long as the transaction was fair to the corporation); Del. G. Bus. C. § 144 (regulating ratification of interested transactions). This rule is often defended as an appropriate response to information problems (insiders may be willing to provide better terms than could be had in arms length transactions and apparently corrupt transactions may have benefits that are not obvious to outsiders). Still, the

Directors and CEOs alike need a theory to explain what they are supposed to be doing when they act for the corporation. So long as CEOs accept that they do not own the corporation, they need to justify distributing corporate assets to themselves. For the last generation, the easiest justification has been that high CEO salaries are good for the shareholders.

Occasionally, CEOs, trapped in the metaphor of a corporation as a thing with an owner, have concluded that the shareholders' lack of ownership means that the CEO is the owner. Indeed, the CEOs of modern publicly traded corporations have most of the legal rights of control and use that ordinarily are associated with ownership. The same authority of the board to operate the company under the protection of the business judgment rule with minimal input from shareholders that proves that shareholders do not own the company, sometimes suggests that top managers, who typically do have significant power over the board, perhaps are owners. CEOs who succumb to this illusion, however, are likely to end badly. CEOs are no more owners of the firms they run than mayors are owners of their cities or Presidents of the country. The legal system gives incumbent management vast discretion in determining how to use corporate assets, even when much of that use is purely for the CEO's benefit–so long as the CEO maintains the distinction between corporate funds and his own.

The same culture that celebrates highly paid CEOs is delighted to take down corrupt ones. Even the imperial CEO must remember that he is merely an officer of the corporation, not its owner; that million dollar salaries are fine, but using corporate funds to pay for personal shower curtains is not. Smart CEOs, then, remain in their role as agents of the firm, not its principal. Acknowledging that their power comes from office, not ownership, they must find a way to justify their actions as in the interests of the firm.

b. The benefits of share-centeredness to CEOs

CEOs have found that rhetorically reducing the corporation and its interests to the shares and their interests justifies corporate decisions to squeeze (lesser) employees, on the ground that increasing profit at the expense of wages is in the interest of the shares, at the same time as it justifies granting a large part of the surplus to top management, on the grounds that top managers, unlike other employees, must be enticed rather than coerced into doing their best, and that high, stock-based, pay will tie their interests to those of the shares.

Moreover, the rhetoric of share-centeredness conceals one of the key problems with the increasing pay of CEOs. Most companies require a degree of employee loyalty to survive and prosper. Employee loyalty, in turn, is best encouraged by appealing to team spirit–convincing the employees that the company's interest is their interest. But the rapidly increasing income and status gaps between CEOs, as team captains, and their employees, as team players, is obviously destructive of esprit de corps. No one likes to be a sucker, and when one player gets all the prizes, the others are likely to begin to feel that

information problems are identical in the public sector and, indeed, seem more likely to be correlated to scale than business form, so this explanation is not altogether satisfactory.

the game is fixed. A certain degree of egalitarianism is essential to create the sense that "we are all in this together" that is, in turn, nearly always the most effective way to induce employees to work.

For these reason, any credible organizational theory will have difficulty justifying vast gaps between leaders and led as a sound way to run an organization. The opposite is more nearly the case: Ordinary understandings celebrate generals who are in the thick of the troops, not emperors who rule from distant palaces.

Firms are bureaucracies, and any bureaucracy is limited by its ability to process information up and down the hierarchy. Vast social gaps between the decision-makers at the top and the actors at the bottom predictably lead to bad decisions and poor implementation. This is why we expect democratic armies to out-perfom aristocratic ones and egalitarian capitalist economies to outperform dictatorial ones of the left or the right. No doubt, alternative stories can be told–perhaps there are leaders who are so smart and so charismatic that they can successfully lead without communication from those below them–but their proponents fight an uphill battle. Astronomical CEO salaries, prima facie, will look like dereliction of duty if the core of the CEOs duty is to rally the troops or listen to them (and the relevant troops are the employees).

Share-centered understandings of the corporation–by defining the corporate team as its shareholders, labeling the employees outsiders, and suggesting (at least implicitly) that the only tools available to induce employee work are market pay and the threat of firing– make this common-sense understanding of internal corporate dynamics less obvious.

If CEOs are seen as chief executives of political-like organizations dedicated to creating a public service (in the form of useful products or decent jobs), or even if they are merely leading an organization with its own will-to-live, the pay and perquisites of recent decades will seem dysfunctional, disturbing, and prima face indications of dereliction of duty. Dictators, not democratic leaders, use their positions to enrich themselves.

In contrast, the share-centered view of the corporation conveniently justifies high CEO stock ownership and, therefore, transfers of corporate surplus to top management (with unavoidable leakage to shareholders). If the central problem of corporate leadership is not overcoming the bureaucratic problems of communication but rather assuring that CEOs have common interests with shareholders, high CEO pay will appear not as a central part of the problem but as the solution. CEOs, thus, have a tremendous incentive to accept and promote the share-centered metaphors: in the share-centered corporation, they are doing their duty by making themselves into the new American aristocracy.[136]

4. Where shareholder returns come from

The short answer to the puzzle of shareholder returns, then, is this. Shareholders receive returns because directors and CEOs believe they are entitled to them. That belief is not based in any compelling economic, moral or legal argument. However, CEOs who wish to justify allocating to themselves a significant part of the corporate surplus will find

[136]See supra n. .

the share-centered metaphors of the corporation more comfortable than the alternatives, and CEOs, unlike shareholders, have actual economic and political power in the corporation. Outside the chief executives office, the share-centered metaphors also have some appeal: they offer an explanation of a world that would otherwise seem unfair, exploitative and anti-democratic, and dysfunctional. If corporations exist for the sake of their shareholders, then perhaps their employees, customers and neighbors have no legitimate complaint when they are treated as no more than means to an end not their own. And if you are being treated that way, it may be more appealing to have an explanation than simply a simmering sense of injustice.

VI. The Significance

Shareholders are not entitled to the residual by law or nature. Indeed, the shareholder theory of value–that all extra value belongs to the shareholders–is little more than a mirror-imaged imitation of Adam Smith and Karl Marx's labor theory of value, which postulated that all the returns to enterprise were created by labor and as a matter of natural law belong to laborers. As a matter of economics, the shareholder theory of value is even more wrong than the labor theory of value. Labor alone, without capital, leads to poverty. Capital alone without labor is simply barren. Modern economies require both, as well as elaborate mechanisms for governing them.

A. The Struggle for Surplus is Political

Instead, the struggle for the corporate surplus–the residual–is a political struggle over economic rents, to which no party has any a priori special claim precisely because they would not exist but for the contribution of all the claimants. From an economic perspective, the shareholders, as fully fungible providers of a fully fungible commodity, have less claim than most. From a political perspective, the power of the shareholder claim depends on the power of the shareholder role, which, as we have seen, is more limited than a casual student of the corporate governance literature might imagine.

The key weapons the shares have are two. First, an ideological claim to entitlement, founded in the metaphors of ownership, contract and agency. A full explication of the rhetorical force of these metaphors is beyond the scope of this essay.[137] However, it should now be clear that their force is indeed simply rhetorical. As a matter of law, neither property, contract nor agency entitle shareholders to the residual; indeed, if the shares had the rights associated with those rules, they would have no need of ideological claims in order to seize what would be their own. It is precisely because public shareholders are not as such owners of the corporation, not entitled to the residual by contract, and not the principals of the corporation that defenders of shareholder entitlements feel the need to so strenuously insist that they are. As a matter of extra-legal moral claim, the claim that shareholders ought to be treated as if they were owners or principals or as if they had contracted for rights they have not obtained in the market is simply a demand for redistribution to the rich.

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[137]See supra n. .

Second, in recent decades, top management has found the rhetoric, and sometimes the reality, of share-centeredness useful for its own purposes. Managers, nearly everyone agrees, are fiduciaries for the corporation with no independent claim to ownership or entitlement. So long as this remains the law and the social understandings, CEOs must justify their actions as on behalf of the corporation, not themselves. The share-centered views of the corporation conveniently rationalize high CEO pay and perquisites–if CEOs are major shareholders, they are more likely to think like shareholders than like employees. Moreover, by making the stock market rather than the bureaucracy central to corporate life, the share-centered metaphors distract attention from the dysfunctionality of disconnected and elite leaders.

B. Making Political Sense of the Corporation's Struggles

If the shareholders' claim to the residual is an ideological demand for rents in a fundamentally political struggle for power within the corporation, it follows that we are free to debate the merits of their claim. We are free to intervene to help or hinder the stock market's attempts to remake the world in its image, without fearing that we are fighting an ineluctable rule of capitalism. Indeed, we are free even to intervene to help employees–or any other corporate participant–to win more of the corporate surplus. The corporate world will survive if shareholders earn returns of 8% rather than 18% or if employees routinely took virtually all the gains of increased productivity instead of, as has been the pattern of the last several decades, virtually none. Efficiency never requires that one particular party win the surplus from cooperation.

As Coase pointed out long ago, the primary explanation for the corporate dominance of our economy is that the bureaucratic business form is able to out-produce markets.[138] Corporations create value that would not exist absent the enterprise itself. The legal rule that corporate surplus belongs to the corporation reflects the underlying reality that it is a product of the corporation itself–that is, it is a result of the cooperative enterprise of all the various corporate stakeholders. Corporate surplus is the gains from the enterprise, not from any one or another of its participants.

Any realistic view of corporate law must begin, then, with the reality of the corporation. Like most collective wholes, social or otherwise, corporations are more than simply the sum of their parts. Just as dividing an individual human into her component organs, cells or chemicals would provide only a partial view of the complete person, dividing a corporation into its parts hides something key.

The corporate entity is a self-governing, partially autonomous, semi-sovereign organization. Its internal decision-making is affected by market pressures, but is no more the unmediated deterministic result of market conditions than any other political decision. Rather than being the simple result of free contracting in a spot market, the internal processes of corporations are complex mixtures of bureaucracy, contract, and agency, under the supervision of a board answerable to its nominal subordinate the CEO, to its electors (the shareholders voting according to the plutocratic principle of one-dollar one

[138] Coase, supra n. .

vote), to the stock market as a whole through its determination of stock price, and to the legal fiction of an undiversified shareholder with no other interest in the corporation or the societies in which it functions.[139]

Looking at the firm in this way, the next steps in the debate are obvious. If corporations are semi-autonomous, semi-sovereigns with many state-like characteristics, they are remarkably unsatisfactory quasi-states in a democratic world. Most of their constituents have no vote at all. The one role that does, shareholders, has its votes allocated per dollar instead of per person. The power of the leader is near dictatorial; if CEOs don't have the power of torture or the gulag, they do retain the right of summary expulsion from the community. We have no adequate countervailing structures inside the organization to balance foolish or corrupt leaders–there is no internal corporate equivalent to cabinet government, ombudsmen, separation of powers or even the rule of law and judicial review.

Poor corporate organization is not so disastrous as dictatorial political government because corporations are more restrained by the market. In the medium run, truly inefficient or corrupt organizations are killed by market competition. Still, when an Enron or a Drexel Burnham is destroyed for corruption or a major airline, old-line steel corporation or major automobile company collapses out of incompetence or excessive rigidity, many innocent people suffer, losing jobs, pensions and communities. This disruption, of course, is not nearly so bad as the warfare typically necessary to overthrow seriously dysfunctional governments, but nonetheless it creates a significant amount of unnecessary human suffering. Darwinian selection is almost as cruel and coarse a tool for regulating human societies as in nature–if we have the option of intelligent design to make functional organizations, we ought to use it.

C. Beyond Determinism: Market Pros and Cons

The theories of economic determinism failed in the communist regimes. They fare no better in the capitalist ones. The role of shareholders in the public corporation is open for debate.

The stock market has proven immensely useful in offering start-up funding for certain kinds of organization. Perhaps, it also provides an insurance function for established firms, helping less diversified corporate participants to weather the inevitable fluctuations of life under capitalism. The market effectively assimilates certain types of public information and usefully signals the consensus (although if the market consensus were an adequate basis for running companies, managers would be unable to charge anything for their services).

On the other hand, the stock market is unable to reflect the full range of human values important to a democratic society. It values only what is priced; whatever cannot be bought is of no interest to it. The capital markets are time and risk indifferent, since they can discount the future to the present and diversification eliminates particular

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[139]On the legal fiction of a shareholder, see *Fictional Shareholders*, supra n. ; on the varieties of decision-making procedures in a democratic polity, see *Beyond the Counter-Majoritarian Difficulty*, supra n. .

commitments; people, however, are always deeply situated and can exist only in particular places, at particular times, and with particular projects. The market, therefore, will always press us in the direction of the radical revolutions and creative destructions of capitalist markets even when all of us might be inclined to be a little more conservative.

Diversified portfolios have no strong interest in the sorts of competition that are essential for capitalist functioning; a shareholder that holds both Delta and Southwest rationally should not care which business model prevails. Instead, competition between different models of air service will appear as no more than an unfortunate way to divert corporate profits to consumers (who, unfortunately, are not publicly traded).

Not least, markets redistribute wealth upwards, but never downwards. Voluntary trade can happen only when both sides find them worthwhile and the diminishing marginal utility of money assures that the rich will always require more of an inducement than the poor. Thus, giving governance of our most powerful institutions to the stock market guarantees that they will be forces for inegalitarianism. It is not accidental that the increased power of the stock market in our public corporations since the 1980s coincided with the enormous expansion of the pay gap between top executives and ordinary employees. Inequality, in turn, is deeply troubling both from democratic and economic perspectives. Inside the corporation, greater inequality necessarily leads to decreased solidarity; employees who think they are being taken by the company are more likely to take from it.[140] Outside the firm, relative equality is a prerequisite both to democratic republican government and to avoiding Keynsian demand-deficit depressions.

D. Conclusion

The issue of how much power to give to the stock market, how much to give to democratic processes, and how much to leave to unguided professionals is the key political question of the corporation. The distribution of the surplus is part of the issue, but perhaps less important than more fundamental issues of how we want our public corporations to operate, towards which goals, and with what relationship to the people who make them up.

So far, the defense of the share-centered corporation has proceeded mainly by invoking rhetorical claims to a supremacy that simply does not exist. But metaphors of ownership or agency are no substitute for social analysis–the question is not whether shareholders "are" owners of the corporation but whether giving them so much power in the corporate governance structure is good for society as a whole.

The alliance of convenience between CEOs and the stock-market has proven only partially productive, and the metaphors of share-centeredness have not helped us to

[140]See, e.g., ALCHIAN & DEMSETZ, supra n. at 790 (describing team spirit or loyalty as useful because it reduces shirking); EMILE DURKHEIM, SUICIDE 381 (Spaulding, trans., Free Press 1951) (on the importance of solidarity); E. ALLAN LIND & TOM R. TYLER, THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE (1988) (showing that employees react to perceived injustice by exploiting the employer back). Similarly, perceived justice is essential if those the institution wishes to reprimand are to see and react to sanctions as punishment (to be internalized) rather than oppression (to be resisted). See, .e.g., Daniel J.H. Greenwood, *Restorative Justice & The Jewish Question*, 2003 UTAH L. REV. 533, text at n. 59 (2003) (describing the significance of the punishment/oppression distinction).

understand the world we live in. The academic task is, first, to fully elucidate the false metaphors, and second, to shift the debate's imagery to metaphors that illuminate instead of concealing. The political task is to find a model which produces wealth for all, not just a small elite; which promotes decent work places and productive careers, not just consumers' playgrounds; which respects our ecosphere, not just a narrow vision of the econosphere.